85-1405

No. ____

FILED
FEB 21 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

RODERICK J. MACKENZIE, MALCOLM L. MACKENZIE and DAVID H. MACKENZIE, INC.,

Petitioners,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented

1. Contrary to the rule in *James v. United States*, 366 U.S. 213 (1961), should this Court hold that the substantial existence of uncertainty in the governing substantive tax law is completely inapplicable in a federal criminal tax proceeding absent a showing by the defendant that he actually knew of and was misled by the uncertainty?

2. Whether § 530 of the Revenue Act of 1978, terminating employers' employment tax liabilities under certain circumstances,—expressly enacted by Congress in response to the widespread confusion, uncertainty and arbitrary enforcement of the employment tax distinction between employees and independent contractors—can be ignored in a criminal tax prosecution for an employer's failure to withhold due to the misclassification of workers as non-employees.

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No. ____

RODERICK J. MACKENZIE, MALCOLM L. MACKENZIE and DAVID H. MACKENZIE, INC.,

Petitioners,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Roderick J. MacKenzie, Malcolm L. MacKenzie and David H. MacKenzie, Inc. pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on November 20, 1985 and the order denying the petition for rehearing entered on January 21, 1986.

Opinions Below

The opinion of the court of appeals is reported at 777 F.2d 811. The Order On Petition For Rehearing is not yet reported. Both the opinion and the order on rehearing are reprinted in the Appendix (1a and 25a)[1] to this petition. The district court

1. References in this petition are indicated as follows:
   1. To the numbered pages of the Appendix to this petition (____a).
   2. To the numbered pages of the trial transcript (Tr. ____).

entered written rulings on certain post-trial motions which have not been reported (131a, 141a).

Jurisdiction

The judgment of the court of appeals was entered on November 20, 1985. A timely petition for rehearing was filed on December 3, 1985. On December 18, 1985, the court of appeals invited the Government to file a response to such petition which was filed on December 23, 1985. A reply to the response was filed by petitioners on December 30, 1985, and the order denying the petition for rehearing was entered on January 21, 1986 (25a). The jurisdiction of this Court is invoked in accordance with 28 U.S. § 1254(1).

Questions Presented

1. Contrary to the rule in *James v. United States*, 366 U.S. 213 (1961), should this Court hold that the substantial existence of uncertainty in the governing substantive tax law is completely inapplicable in a federal criminal tax proceeding absent a showing by the defendant that he actually knew of and was misled by the uncertainty?

2. Whether § 530 of the Revenue Act of 1978, terminating employers' employment tax liabilities under certain circumstances,—expressly enacted by Congress in response to the widespread confusion, uncertainty and arbitrary enforcement of the employment tax distinction between employees and independent contractors—can be ignored in a criminal tax prosecution for an employer's failure to withhold due to the misclassification of workers as non-employees.

Constitutional and Statutory Provisions Involved

Fifth Amendment

No person shall be . . . deprived of life, liberty, or property, without due process of law. . . .

Section 530, Revenue Act of 1978, Pub.L.No. 95-600, 92 Stat. 2763, 2885-86 (codified at 26 U.S.C. § 3401 note):

CONTROVERSIES INVOLVING WHETHER INDIVIDUALS ARE EMPLOYEES FOR PURPOSES OF THE EMPLOYMENT TAXES.

(a) TERMINATION OF CERTAIN EMPLOYMENT TAX LIABILITY FOR PERIODS BEFORE 1980.—

(1) IN GENERAL.—If—

(A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period ending before January 1, 1980, and

(B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,

then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

(2) STATUTORY STANDARDS PROVIDING ONE METHOD OF SATISFYING THE REQUIREMENTS OF PARAGRAPH (1).—For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a

period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

(A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(B) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or

(C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

(3) CONSISTENCY REQUIRED IN THE CASE OF 1979 TAX TREATMENT.—Paragraph (1) shall not apply with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980; if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for any period beginning after December 31, 1977.

(4) REFUND OR CREDIT OF OVERPAYMENT.—If refund or credit of any overpayment of an employment tax resulting from the application of paragraph (1) is not barred on the date of the enactment of this Act by any law or rule of law, the period for filing a claim for refund or credit of such overpayment (to the extent attributable to the application of paragraph (1)) shall not expire before the date 1 year after the date of the enactment of this Act.

(b) PROHIBITION AGAINST REGULATIONS AND RULINGS ON EMPLOYMENT STATUS.—No regulation or Revenue ruling shall be published on or after the date of the

enactment of this Act and before January 1, 1980 (or, if earlier, the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment taxes) by the Department of the Treasury (including the Internal Revenue Service) with respect to the employment status or any individual for purposes of the employment taxes.

(c) DEFINITIONS.—For purposes of this section—

(1) EMPLOYMENT TAX.—The term "employment tax" means any tax imposed by subtitle C of the Internal Revenue Code of 1954.

(2) EMPLOYMENT STATUS.—The term "employment status" means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee).

United States Code, Title 26: § 7206(1) and (2)
Fraud and False Statements

Any person who—

(1) Declaration under penalties of perjury.—Willfully makes and subscribes any return, statement, or other document, which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe to be true and correct as to every material matter; or

. . .

(2) Aid or assistance.—Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent

> of the person authorized or required to present such return, affidavit, claim, or document . . .
>
> shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Statement of the Case

Petitioners—a father, a son and their family painting business—were convicted on all applicable counts following a jury trial presided over by Judge Burns of the United States District Court for the District of Connecticut. Each conviction arises from petitioners' failure to withhold federal employment and social security taxes from payments made to workers due to a misclassification of such payments as compensation to independent contractors rather than as wages to employees.[2] The prosecution—apparently only the second if its kind[3]—was initiated notwithstanding the widespread uncertainty in the classification of workers expressly recognized by Congress in its enactment of § 530 of the Revenue Act of 1978, a "safe haven" against enforcement of disputed employment taxes if there exists any "reasonable basis" for the employer's behavior and if a specific "consistency" requirement is met.

Although it has operated consistently as a "union shop" since its establishment in 1919, the MacKenzie firm began, in the early 1970's, to rely more frequently on non-union workers

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2. Roderick MacKenzie faces a ten thousand dollar fine, a thirty day prison sentence and one year's probation based on convictions under 18 U.S.C. § 371, 26 U.S.C. § 7206(1) and § 7206(2). Malcolm, his son, faces a six month prison term and two years probation based on convictions under 18 U.S.C. § 371 and 26 U.S.C. § 7206(2). The family corporation was sentenced to a ten thousand dollar fine under 18 U.S.C. § 371.

3. The only other reported tax prosecution dealing with misclassification of workers is *United States v. McLaughlin*, 663 F.2d 949 (9th Cir. 1981) (reversing conviction based on evidentiary error).

and other self-employed individual and corporate sub-contractors in addition to workers provided by the Painters' and Allied Trades Union (Tr. 6457-60, 6474, 6646). Apart from its superintendent, neither union nor non-union workers were used on a full-time, exclusive basis, but were used as needed on a seasonal basis by the MacKenzie firm as well as by other painting contractors in the region.

In an effort to compete effectively in the building trades in southern Connecticut and partly to avoid the overtime bonus restrictions imposed by the union contract, the family firm, in the period covered by the indictment, expanded the number of worker payments it treated as independent contractor compensation. The firm compensated all workers—both individual and corporate—that it deemed indpendent contractors by handwritten corporate check without adjustments for federal employment taxes or union benefits (Tr. 6459-60). The earnings referred to in both the filed quarterly employer's returns (Forms 941) and the filed year-end Wage and Tax Statements (W-2 Forms) reflected only those cumulative amounts paid by the MacKenzie firm through its standardized payroll checks (Tr. 1581-83).

Certain union workers who specialized at hanging wall covering were paid on a piecework rather than an hourly basis (Tr. 6648, 6650-61), even though the union contract prohibited any method of compensation other than payment by the hour. To avoid complaints by the union, and with the consent of the wall covering workers in question, compensation to these workers for their piece work, was treated in the same manner as the compensation paid to the self-employed independent contractors utilized by the firm.

A second form of compensation was paid to Dennis McDivitt on painting projects contracted by the MacKenzie Company, the non-union branch of the family business established by Malcolm in early 1977. Although initially paid on a lump-sum basis, McDevitt eventually began to submit handwritten lists of the total man-hours worked with the corresponding

names of the individuals working on projects under his supervision. McDevitt made payment to individual workers from MacKenzie Company checks made payable to him (Tr. 2714). After being alerted that McDevitt and his men might be deemed employees of the MacKenzie firm for employment tax purposes (Tr. 6596-97), Malcolm established a formal payroll in mid-1979 for those of McDevitt's workers requesting treatment as direct employees. For those workers who did not so elect, the firm, on the advice of its accountant, prepared Forms 1099 (required if a non-employee is paid $600.00 or more in a calendar year, *see* 26 U.S.C. § 6041(a) and Treas. Reg. § 1.604-1) reflecting the total amount of non-payroll compensation paid each worker in 1979.

A third method of payment involved workers on projects for which the firm was not reimbursed for the overtime premiums required under the union contract (Tr. 6677). These workers agreed to be paid for their overtime and holiday hours on such projects on the following basis: the "straight" hourly base rate called for by the union contract, rather than the one-half or double time required, plus an additional amount equalling the employer's required hourly contribution to the union health and pension funds (Tr. 6670-72). As was the case with the piecework compensation, these "gross amount" payments were made by separate, non-payroll checks, without federal withholding or union deductions, and were not included in the payroll totals reported to the IRS in the quarterly 941 forms or the year-end W-2 forms for the years in question.

The Forms 1099 for most of those workers treated by the firm as independent contractors were not filed until early 1980. Malcolm had not been aware of the existence of a 1099 form until early 1979 when so informed by the firm's accountant, who, at that time, advised against filing these forms. Finally, in December, 1979, the accountant recommended that the MacKenzies prepare and issue 1099 forms to individual union workers and file the completed forms with the IRS reflecting the total amount of non-payroll compensation paid in 1979 (Tr.

5643, 6726). The 1099 forms for 1979 were completed in early 1980, but their issuance delayed on the advice of the firm's attorney.

Throughout the trial, the district court struggled with what it characterized as a " 'novel' " legal question (143a), namely the impact on this criminal prosecution of both the widespread and long standing uncertainty in employment tax classifications of employees and independent contractors and of the congressional response to that uncertainty embodied in the so-called "safe haven" for employers found in § 530 of the Revenue Act of 1978, Pub.L. No. 95-600, 92 Stat. 2763, 2885-86. Section 530 is a virtually unprecedented tax statute enacted to eliminate controversies between taxpayers and the IRS over whether certain individuals had the status of employees of the taxpayers. (The Report of the Comptroller General detailing the confusion and uncertainty in the adminstration of these employment tax rules, particularly in industries such as building trades and construction, is reproduced in the Appendix at 46a and is discussed below). Ultimately the district court concluded that both the uncertainty and confusion surrounding the employee classification issue and the existence and content of § 530 could be ignored in this criminal proceeding.

For example, the district court ruled that petitioners were barred from introducing any evidence or cross-examining Government witnesses about the existence of the legal and practical confusion in the employee-independent contractor distinction for employment tax purposes (Tr. 3656-67), even though the Government itself was, for example, unable to state at trial at what point it regarded Dennis McDevitt's status as having changed from that of independent contractor to employee (7a) (Tr. 21-24, 2675). Secondly, notwithstanding its express holding that the "reasonable basis" standard for according an employer relief under § 530 "is an objective test" (136a), the district court excluded testimony that petitioners might have complied with that objective standard and also refused their request for jury instructions which would have described the

confusion leading to the enactment of § 530, and/or which would have set forth the existence and terms of § 530 itself (136a-137a, 138a-139a). Finally, the trial court denied timely filed motions for judgments of acquittal and for a new trial which, *inter alia*, rested on its denial of evidence and jury instructions relating to the uncertainty of the tax law requirements and to § 530 (131a).

On appeal from the convictions, the court of appeals held that neither evidence nor jury instructions relating to the uncertain state of applicable tax obligations should be permitted in a criminal tax prosecution absent evidence that the taxpayer-defendant "genuinely thought that what he was doing was lawful and proper" (16a). In addition, the court of appeals held that petitioners were not entitled to jury instructions relating to § 530, concluding that "the requirement of specific intent in this crime negates the availability of a section 530 defense" (15a). In reaching this conclusion, the court of appeals, in contrast to the district court, held, based upon a Senate Report which had accompanied an unenacted version of § 530, that the exculpatory "reasonable basis" standard of the statute was not an objective test, but one requiring the employer-taxpayer to act in "good faith" (14a). In its subsequent Order on Petition For Rehearing (25a-27a), the Second Circuit panel reaffirmed these conclusions, although it acknowledged that its prior judgment (15a-16a) that petitioners' failure to file Forms 1099 for years prior to 1979 violated the "consistency" requirement of § 530 had been in error (27a).

Reasons for Granting the Petition

This case involves two important issues of federal tax law. The first concerns the proper application of the requirement of willfulness in federal tax crimes under circumstances where the substantive tax law is highly uncertain; the decision below on this important and recurring issue cannot be reconciled with the decision of this Court in *James v. United States*, 366 U.S.

213 (1961), and is in direct conflict with recent decisions of the courts of appeals of three other circuits.

The second issue involves a novel and unwarranted interpretation by the court below that § 530 of the Revenue Act of 1978 has no application in a criminal proceeding. The decision of the court of appeals on this issue, not only has deprived defendants of a fair trial, but also dramatically upsets a carefully constructed statutory scheme designed by Congress to eliminate the potential for widespread litigation and administrative controversies over the important employment tax distinction between employees and independent contractors. By erroneously holding this statute to have no application whenever the Government chooses to bring a criminal proceeding prior to a civil case and by converting the objective exculpatory standard selected by Congress into a subjective inquiry, the court below has created the very horror that Congress was attempting to avoid: a widespread potential both for the arbitrary enforcement of the withholding provision and for a flood of litigation in the federal courts.

I.

A. In *James v. United States*, 366 U.S. 213 (1961), a majority of this Court agreed that the willfulness necessary to sustain a criminal tax conviction of an embezzler could not be proven in light of the uncertainty at that time under the substantive tax law that embezzled funds were includible in the embezzler's taxable income. Although it concluded that the embezzled funds should have been included in James's income, this Court reversed his conviction for wilfully attempting to evade taxes and directed the district court to dismiss the indictment. In so doing, it rejected Justice Harlan's explicit request (joined by Justice Frankfurter) that James' conviction be vacated and a new trial ordered to determine whether—despite evidence below that James' " 'acts were done in a knowing and conscious attempt to evade and defeat' his tax obligations,"—the defendant himself had been aware of the

uncertain state of the tax law; whether "misapprehension may have existed in the mind of the petitioner as to the applicable law, in determining whether the Government had proved that petitioner's conduct had been willful as required by the statute." 366 U.S. 242 at 244, 248.

The lower courts therefore subsequently applied *James* to hold that even though embezzled funds were properly includible in taxable income for years prior to the Court's resolution of this uncertain tax issue, neither civil nor criminal tax fraud penalties could be applied. *Compare, e.g., Estate of Geiger v. Commissioner*, 352 F.2d 221 (8th Cir. 1965) (holding funds embezzled prior to the *James* decision were includible in taxable income), *cert. denied*, 382 U.S. 1012 (1966), *with Kahr v. Commissioner*, 414 F.2d 621, 627 (2d Cir. 1969) (holding that *James* not only precluded criminal penalties for failure to include embezzled funds in income during the period prior to the *James* decision, but also that the uncertainty of the substantive tax law necessarily barred a finding of the "identical" element of willful specific intent required under the civil tax fraud statute: "Kahr, like James, . . . *could not, in legal contemplation*, have formed the intent necessary to commit a tax fraud.") (emphasis added).

Although this Court has on several occasions subsequent to *James* reviewed cases applying the willfulness requirement, it has never retreated from its holding in *James* that where the tax law is uncertain, a conviction for willful violation of the tax laws cannot stand;[4] nothing this Court has subsequently

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4. This Court's decision in *James* is obviously related to the general constitutional standard of fair notice in the due process and vagueness contexts. In fact, a student law review note, cited approvingly by both the Sixth Circuit in *United States v. Curtis*, No. 85-5070 (6th Cir. Jan. 28, 1986) (117a) and the Second Circuit in *United States v. Ingredient Technology Corp.*, 698 F.2d 88 (2d Cir.), *cert. denied*, 462 U.S. 1131 (1983) (both of which are discussed below) has argued that both the Supreme Court in *James* and the lower courts have been in error in following *James* in treating the problem of tax law uncertainty as mitigating the willfulness requirement of criminal tax provisions rather than as one of constitutional import. Note,

said undermines its rejection in *James* of Justice Harlan's suggestion that the defendant must demonstrate either good faith reliance on a favorable interpretation of the law or a personal "misapprehension" as to its content.[5] Moreover, this Court's rejection of the suggestion that a defendant should be required to show that he personally was misled by the uncertainty in the relevant tax law is sound indeed because imposing

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Criminal Liability For Willful Evasion of An Uncertain Tax, 81 Colum. L. Rev. 1348 (1981). To the contrary, petitioners believe this Court was sound in *James*, as have been the Fourth, Fifth and Ninth Circuit decisions described below, in treating the substantive issue of uncertainty in the tax law as one involving the impossibility, as a matter of law, of the Government establishing willfulness, rather than as one of constitutional vagueness, which might have widespread and unforeseeable ramifications on criminal statutes outside the tax context. Both the detailed civil and criminal sanction structure of federal tax law and the nature of uncertain tax requirements suggest that a rule appropriate to a criminal tax prosecution may not always be proper in non-tax areas. We have, therefore, advanced the argument here as one based on the tax statutes rather than relying solely on the Constitution.

5. In *United States v. Pomponio*, 429 U.S. 10, 12 (1976) this Court described willful conduct as "voluntary intentional violation of a known legal duty." Identical language was used in *United States v. Bishop*, 412 U.S. 346, 360 (1973), in holding that the willfulness requirement is identical in federal tax felony and misdemeanor provisions. As the Fourth Circuit Court of Appeals recognized in *United States v. Mallas*, 762 F.2d 361, 363 (4th Cir. 1985), this test "requires that the duty involved must be *knowable*." (citing *James*) (emphasis added). The oft-quoted language in *Bishop* (quoted in the opinion below, 18a) that the willfulness requirement is meant "to separate the purposeful tax violator from the 'well-meaning but easily confused mass of taxpayers' ", 412 U.S. 346 at 361, in no way undercuts this Court's holding in *James* but merely makes it clear that if the taxpayer can show a bona fide misunderstanding of the requirements of the law, he cannot be convicted even if that subjective belief were objectively *un*reasonable. *See, e.g., United States v. Aitken*, 755 F.2d 188 (1st Cir. 1985) (court reversed conviction, rejecting Government's argument that lack of an objectively reasonable basis for failing to comply with tax obligations was sufficient to convict absent proof of a subjective intent to disobey the tax law). Subjective intent to violate the law is therefore a necessary element of willfulness, but as *James* teaches, subjective intent to violate the law alone is not sufficient to establish a tax crime; the defendant must also be allowed to show that the substantive requirements of the relevant tax law are, as an objective matter, sufficiently confused or uncertain that a criminal tax conviction would be inappropriate.

such a personal reliance requirement would not only prejudice unadvised or ill-advised defendants vis-a-vis well-advised ones, but also would, in effect, shift an important aspect of the Government's burden of proving the critical element of willfulness to the defendant and would significantly undercut defendants' abilities to exercise, without prejudice, their Fifth Amendment rights to refuse to testify in criminal proceedings.[6]

The *James* decision barring criminal tax convictions in the face of uncertain substantive tax law strikes an appropriate balance. It recognizes that the trial and appellate courts are perfectly capable of rejecting frivolous claims of uncertainty, *see, e.g., United States v. Burton*, 737 F.2d 439, 441-42 (5th Cir. 1984) (rejecting defendants' claim that the tax law requirement that wages qualify as income is uncertain); but, at the same time, appropriately limits the Government's ability to use necessarily selective criminal tax prosecutions as occasions for advancing highly debatable, uncertain or novel theories of tax law.

B. Second, the courts of appeals are in disagreement over whether, notwithstanding *James*, a defendant may still be required to show that he personally was aware of or misled by the uncertainty in the relevant tax law. The court below erroneously rejected this Court's holding in *James* (albeit without discussion or citation) and instead adopted the requirement discarded in this Court that, even in the face of admittedly uncertain law, the defendant must show that he "genuinely thought that what he was doing was lawful and proper." (16a). The decision of the court below would ignore uncertainty in the law unless "the requirements in issue under the Tax Code *are so muddled that the taxpayer is genuinely uncertain* about their applicability"[7] (16a) (emphasis added).

6. This burden shifting to petitioners in this case was further compounded by the district court's jury instruction permitting satisfaction of the willfulness standard by inferences "that a defendant deliberately closed his eyes to what should otherwise have been obvious to him." (17a).

7. This requirement that the defendant must always prove his own uncertainty was previously suggested by the opinion of the Second Circuit

This requirement of the Second Circuit below has also subsequently been adopted by the Sixth Circuit Court of Appeals in *United States v. Curtis*, No. 85-5070 (6th Cir., Jan. 28, 1986) (reproduced at 117a), where that court (also without citation or discussion of *James*) held that uncertainty in the relevant tax law is not relevant "unless there is a connection between the [uncertainty in the law] and the defendant's state of mind" (129a).

In cases where the defendant fails to meet the requirements of the Second and Sixth Circuit Courts that he show that he is "genuinely uncertain" about the relevant tax law, both of these circuits have adopted evidentiary rules and approved jury instructions that keep from the jury any clue that the Government has brought a criminal prosecution under an uncertain or unsettled substantive tax provision. Even if the trial judge agrees with the defendant's contention that the tax rule at issue is extremely uncertain or highly debatable, but ultimately accepts the Government's, rather than the defendant's, interpretation of the uncertain law, the Second and Sixth Circuits have held that the defendant is neither entitled to present any evidence concerning the law's uncertainty nor to any jury instruction indicating the existence of the uncertainty. The jury is therefore presented such cases in precisely the same manner as cases where the law is indisputedly clear—that wages are income, for example. Thus, in the instant case, although the district court conceded that the substantive legal issue was " 'novel' " and critical to the validity of the Government's prosecution (143a) and that the provisions of § 530 allow employers to "treat employees as non-employees if there is a

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Court of Appeals in *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 96-97 (2nd Cir.), *cert. denied*, 462 U.S. 1131 (1983), but that case also suggested that the relevant tax law had no "lack of clarity," *id.* 96 n.8, and has, at least by some courts, been interpreted as holding that expert testimony about uncertainty in the applicable tax law duty is not admissible, but that whether the law is uncertain is a question for the judge. *See United States v. Mallas*, 762 F.2d 361, 364 n.4 (4th Cir. 1985).

reasonable basis for doing so" (136a), petitioners were precluded from offering any evidence—or even cross-examining Government witnesses—either about any reasonable basis for their conduct or the uncertainty of the substantive law. In addition, the court of appeals upheld jury instructions that easily might have conveyed to the jury the erroneous impression that this case was nothing more than a routine prosecution for violation of a clear and unambiguous legal requirement, rather than only the second reported prosecution for misclassifying workers as independent contractors for tax years governed by § 530.

The decisions of both the Second Circuit below and the Sixth Circuit in *Curtis*, as explicitly recognized in the latter opinion (129a), are in direct conflict with recent decisions of the Fourth, Fifth and Ninth Circuit Courts of Appeals. *See United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974), *United States v. Dahlstrom*, 713 F.2d 1423, 1427-28 (9th Cir. 1983), *cert. denied*, 104 S.Ct. 2363 (1984), *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979) (en banc), and *United States v. Mallas*, 762 F.2d 361 (4th Cir. 1985).[8] These courts of appeals have followed *James* in holding that the relevance of the uncertainty in the substantive tax law "does not depend on whether the defendant actually knew of the conflict." *United States v. Garber*, 607 F.2d. 92, 98, *citing United States v. Critzer*, 498 F.2d 1160.[9] *See also United States v. Dahlstrom*, 713 F.2d 1423

8. There seems to be an additional conflict among the Fourth Circuit, on the one hand (which in this matter seems to agree with Second and Sixth), and the Fifth and Ninth Circuits, on the other, about the admissibility of expert testimony regarding the uncertainty of the tax law and the proper allocation of the determination of that issue between judge and jury. We do not raise that issue here, although we do question both the evidentiary rulings and the propriety of the jury instructions below. *Compare United States v. Mallas*, 762 F.2d at 364 n.4; *United States v. Ingredient Technology Corp.*, 698 F.2d at 96-97, and *United States v. Curtis*, slip op. 13-14 (129a-130a), *with United States v. Garber*, 607 F.2d at 98-99 and *United States v. Dahlstrom*, 713 F.2d at 1427.

9. In both *Critzer* and *Garber*, the evidence showed that the defendants had subjectively believed that they were violating the tax laws. *See United States v. Critzer*, 498 F.2d at 1160; *United States v. Garber*, 607 F.2d at 96 n.3, 101.

at 1428 ("It is settled that when the law . . . is highly debatable a defendant—*actually or imputedly*—lacks the requisite intent to violate it' . . . . 'A criminal proceeding . . . is an inappropriate vehicle for pioneering interpretations of tax law.' ") (quoting *United States v. Critzer*, 498 F.2d at 1162 and *United States v. Garber*, 607 F.2d at 100) (emphasis added); and *United States v. Mallas*, 762 F.2d 361 at 363, 364, 365 (the Government's theory of the applicable substantive tax law was "far too tenuous and competing interpretations of the applicable law far too reasonable to justify these convictions . . . [T]he prosecution and the defense can in this situation both offer plausible support for their positions. . . . Criminal prosecution for the violation of an unclear duty itself violates the clear constitutional duty of the Government to warn citizens whether conduct is legal or illegal. . . . As *Critzer* indicates . . . only a 'willful' tax evasion is criminal. Willful conduct . . . requires that the duty involved must be knowable. . . . But without that fair warning, the Government may not institute criminal proceedings.").

In brief, the decision of the Second Circuit Court of Appeals below and the subsequent decision of the Sixth Circuit in *Curtis* would introduce into the tax laws the prospect that defendants may be criminally punished in circumstances that, in the words of the Fourth Circuit's opinion in *Mallas*, "raise novel questions of tax liability to which governing law offers no clear guidance," 762 F.2d at 361, without any opportunity for the defendant to notify the jury that it is considering anything other than a routine prosecution for violation of a clear tax rule. This Court should eliminate the current disarray among the circuits and restore a uniform national rule with respect to this major question affecting the prosecution of federal tax crimes by reaffirming the wisdom of the *James* decision that, although a wide variety of civil sanctions may be imposed even where the substantive tax law is highly debatable, criminal tax cases are an inappropriate vehicle for resolving uncertainties in substantive tax law.

II.

At first glance, § 530 of the Revenue Act of 1978 may appear to be nothing more than merely another technical and obscure federal tax statute, the interpretation of which might safely be left to this nation's lower courts, at least until a clear conflict develops among the circuit courts of appeals. To the contrary, § 530 is an extraordinary congressional enactment intended to terminate employment tax liabilities, eliminate numerous and increasing controversies between taxpayers and the IRS over the classification of workers as employees, and provide relief from all penalties for taxpayers who had any "reasonable basis" for their classification of workers and who had acted "consistently" in treating their workers as non-employees.

Review should be granted in this case because, if left undisturbed, the clearly erroneous interpretation by the court of appeals that this important statute has no application to a criminal prosecution of employers creates great potential for increasing the already heavy burdens of the federal criminal justice system by unleashing a barrage of criminal enforcement in controversies over employment taxes. In enacting § 530, Congress recognized that employment and withholding tax controversies, which potentially might affect a great number of employers, could create havoc in the tax system. In addition, the mistake of the court below in interpreting the "reasonable basis" exculpatory provision of § 530 threatens to cause widespread confusion in the administration of a number of unrelated penalty provisions of the Internal Revenue Code. Finally—in combination with its evidentiary and substantive holdings in dealing with the uncertainty in the substantive tax law (described in Section I of this Petition)—the decision of the court of appeals that § 530 is inapplicable to a criminal proceeding vitiated the government's burden of proving all of the elements of a tax offense and deprived defendants of their constitutional right to a fair trial. The decision below flies in the face of this Court's admonition that tax withholding

obligations deserve special scrutiny: that "[b]ecause the employer is in a secondary position as to liability for any tax of the employee, . . . the employer's obligation to withhold [must] be precise and not speculative." *Central Illinois Public Service Company v. United States*, 435 U.S. 21, 31-32 (1978).

Section 530 was enacted in response to Congress's concern during the mid-1970's about the IRS's administration of the employment tax distinction between employees and independent contractors.[10] The circumstances leading to the enactment of § 530 were set forth in a report to Congress on November 21, 1977 by the Comptroller General:

> The laws defining who is an employee for tax purposes are uncertain, unclear and subject to conflicting interpretations (53a). . . . [The] IRS and business taxpayers frequently disagree over whether various business relationships with individuals are that of employer-employee under the common law definitions. [The] IRS interpretation of common-law employee is more strict—more likely to result in a finding of employee status—than that of business and, in many instances, the courts (56a-57a). . . . [T]he application of the common-law rules to specific employee/self-employed situations is open to broad and inconsistent interpretation. . . . Evaluating the weight to be given to various rules is often a subjective matter (59a). . . . The former director of the IRS Legislative Analysis Division told us it is not uncommon for two knowledgeable individuals to disagree on an employee status determination given the same set of circumstances. . . . [The] IRS has not provided [adequate] guidelines. The results are misclassifications of employees by employers and inconsistent and conflicting interpreta-

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10. Prior to the enactment of § 530 in 1978, the House and Senate conferees on the Tax Reform Act of 1976 had halted the changes in the independent contractor-employee distinctions contemplated by the Internal Revenue Service. H.R. Rep. 94-1515, 94th Cong. 2d Sess. 489, *reprinted in* 1976 U.S. Code Cong. & Ad. News 4118, 4193.

> tions of the common-law rules by IRS personnel in different geographic areas (61a). . . . IRS individual tax audits sometimes treated individuals as self-employed, while agents auditing the business the individuals worked for classified them as employees (62a). . . . [R]eclassifications [include] carpenters, *painters*, entertainers, truck drivers, store managers, nurses, security guards and mechanics . . . [Some] persons being reclassified performed their services on the premises and used the equipment and facilities of the contracting business. . . . Often the difference between an employee and a self-employed independent contractor is difficult to distinguish . . . [The] IRS interprets to the government's advantage and the business interprets to its advantage. (63a)

(Emphasis added.) Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons By the Internal Revenue Service: Problems and Solutions" 660-77-88, 1-11 (November 21, 1977) (reprinted at 46a).[11]

Although the Treasury Department and the Internal Revenue Service agreed that the GAO Report had made an important contribution in urging greater certainty in this important employment tax area, they objected to the GAO's recommended solutions. As a result, Congress failed in 1979, 1980 and 1982 to adopt any solution resolving this important uncertainty in the law; instead, it indefinitely extended the "interim" relief provided by § 530. *See* Pub.L.No. 96-167, § 9(d), 93 Stat.

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11. In a 1979 report on the ongoing independent contractor-employee controversy, the Staff of the Joint Committee on Taxation described § 530:

> Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers. Therefore, the Act allows taxpayers to continue to treat workers as other than employees . . . unless the taxpayers have no reasonable basis for not treating the workers as employees (78a).

1275, 1278 (1979); Pub.L.No. 96-541, § 1, 94 Stat. 3204 (1980); Pub.L.No. 97-248, § 269(c), 96 Stat. 324, 552 (1982).

Although the statute itself is silent on the application of § 530 in a criminal proceeding, its legislative history and subsequent pronouncements both by the cognizant congressional staff and by the Internal Revenue Service have indicated that the relief provided by § 530 should apply to criminal as well as civil penalties. The Staff of the Joint Committee on Taxation and the IRS explicitly have acknowledged that "all . . . interest and penalties" will be "forgiven automatically" whenever a taxpayer is "relieved of liability" under § 530 (90a). A criminal penalty, such as imposed upon defendants here, is undoubtedly a "penalty" which should "automatically" be "forgiven" if § 530 applies. The holding to the contrary of the court below conflicts directly with announcements by the IRS in three separate Revenue Procedures, published in 1978, 1981 and 1985, that § 530, where applicable, eliminates "interest and penalties." *See* Rev.Proc. 85-18, 1985-13 I.R.B. 27; Rev.Proc. 81-43, 1981-2 C.B. 616; Rev.Proc. 78-35, 1978-2 C. B. 536. If Congress secretly had meant to eliminate only civil penalties, but not criminal penalties, surely both it and the Internal Revenue Service had a duty to notify employers of that interpretation.

That § 530 eliminates all penalties, including criminal penalties, is clear from the wording of the statute itself. The title to § 530 is "Termination of Uncertain Employment Tax Liability. . . .," and § 530 explicitly provides that under certain circumstances a worker "shall be deemed not to be an employee." Certainly, if a worker is "deemed not to be an employee," there can be no corresponding duty to withhold; the convictions of petitioners here cannot stand in the absence of a duty to withhold. The analysis of the court below, which suggests that an employer may have no duty to withhold and thus cannot receive any civil sanctions, but nevertheless can be prosecuted criminally and incarcerated, not only abrogates the Government's burden of proving all of the elements of the tax

crimes charged, but also dramatically jeopardizes Congress's purpose in enacting § 530 to eliminate employment tax controversies over employers' misclassifications of workers.[12]

In its original opinion in this case, the Second Circuit grounded its decision that § 530 had no application to this criminal proceeding in its conclusion that the defendants had violated the "consistency" requirement of § 530, a requirement designed by Congress to preclude the "safe haven" relief when a taxpayer changed his treatment of payments to workers following the passage of § 530. The court's original opinion stated:

> [T]he failure to file [Form] 1099s in this case would seem to negate any likelihood that appellants were acting 'consistently' in treating their workers as independent contractors; they are, therefore, not among the employers that Congress intended to protect.

(15a). In its order denying the petition for rehearing, the court below admitted that this was in error and that the defendants had in fact complied with the consistency requirements of § 530, stating:

> Petitioners correctly assert that under § 530(a)(1)(B), their failure to file Forms 1099 before December 31, 1978, did

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12. To support its holding that § 530 has no application in a criminal prosecution against an employer, the court of appeals relied, in part, on *United States v. McLaughlin*, 663 F.2d 949, 952 (14a). However, as the district court here recognized, based on its own review of transcripts of the jury instructions, the assumption of the Ninth Circuit in *McLaughlin* that a jury instruction on the terms of § 530 had been given was mistaken, thereby "weakening" the Ninth Circuit's holding that a " '§ 530 defense' " was properly rejected (143a).

The court of appeals also found significance in the fact that petitioners paid occasional non-payroll compensation to workers who also were "regular employees" (11a). However, the district court, relying on a 1979 IRS General Counsel Memorandum (92a), concluded that § 530 relief might be applicable even where an employer pays the same worker wages in his role as an employee and non-employee compensation in his role as an independent contractor (112a).

> not bar them from taking advantage of § 530, and they are right that the failure to file Forms 1099 did not breach the 'consistency' requirement of the statute, notwithstanding the suggestion to the contrary made in our opinion.

(27a). The court failed, however, to recognize that its reversal on this important issue undermined its earlier conclusion that petitioners were, as a result of not meeting the "consistency" requirement of § 530, "not among the employers that Congress intended to protect." (15a).

Moreover, in barring the application of § 530 to a criminal proceeding, the court of appeals erroneously converted the Congress's objective exculpatory "reasonable basis" standard into a subjective "good faith" requirement, notwithstanding the explicit substitution by Congress of a "reasonable basis" requirement for a "good faith" standard.[13] The decision below threatens to create the very controversies that Congress had intended to avoid in selecting a "reasonable basis" standard; by relying on the superseded subjective "good faith" standard

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13. As enacted, § 530 does not contain the phrase "good faith" although such a requirement had appeared in the discarded Senate version of the bill (43a). The statute as finally enacted instead provides protection to an employer unless he had no *reasonable basis* for not treating [a worker] as an employee." Section 530(a)(1) (emphasis added). The "reasonable basis" standard for employers to qualify for the § 530 protection had been developed by the House Ways and Means Committee (31a), and the Conference Committee on the Revenue Act of 1978 explicitly adopted the House version (28a), rather than the Senate version. H.R. Rep.No. 95-1800, 95th Cong., 2d Sess. 271, *reprinted in* 1978 U.S. Code Cong. & Ad. News 7198, 7266.

In its Order on Petition For Rehearing in the present case, the court below reaffirmed its reliance on the superceded Senate bill and accompanying Report although it acknowledged (26a-27a) that in doing so it was in conflict with the United States Court of Claims' decision in *Ridgewell's, Inc. v. United States*, 655 F.2d 1098, 1104 (Ct. Cl. 1981) (stating that the "legislative history from the Senate Report . . . is no longer accurate when applied to § 530 as enacted."). In choosing the House version, Congress clearly and explicitly accepted a "reasonable basis" standard rather than a "good faith" standard.

the Second Circuit erroneously concluded that § 530 has no bearing on the duty to withhold unless the taxpayer is deemed to have acted with a particular state of mind. The "reasonable basis" standard was adopted by Congress so that the duty to withhold would be defined with reference to an objective standard of behavior, and thereby avoid endless numbers of subjective inquiries about taxpayers' states of mind. In confounding these two standards—both of which have separate but familiar meanings in tax practice—the Second Circuit Court of Appeals has not only ignored important nuances of tax law and deprived petitioners in this case of their constitutional right to a fair trial, but has also potentially introduced enormous confusion into the administration of a wide variety of penalty provisions under the Internal Revenue Code.[14]

Finally, the holding of the court below that § 530 has no application to a criminal proceeding—coupled with the court's holding that uncertainty of the tax law can be ignored in a criminal proceeding (described in Section I of this petition)—has deprived petitioners in this case, and may well deprive an untold number of other unsuspecting employers, of their constitutional right to a fair trial. Under the holdings of the court below, employers facing criminal charges for misclassifying their workers for employment tax and withholding purposes may be precluded from introducing any evidence, expert

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14. The tax law contains a variety of penalty provisions many of which can be avoided by meeting some specific exculpatory standard. In fashioning provisions that forgive taxpayers from penalties that might otherwise apply, Congress is careful to distinguish "good faith" from "reasonable basis" standards. When it means to require *both* good faith and a reasonable basis, it says so. See for example, the tax return preparer negligence penalty, 26 U.S.C. § 6694 and implementing regulations found in Treas. Reg. § 1.6694-1(a)(4). See also 26 U.S.C. § 6661(c) describing circumstances regarded as appropriate to waive the penalty for "substantial understatements" of tax liability; this penalty may be waived if the taxpayer shows that "there was reasonable cause for the understatement . . . *and* that [he] acted in good faith." (emphasis added). The blurring by the court below of an objective "reasonable basis" standard with the subjective "good faith" standard introduces important uncertainties into the administration of the penalty provisions of the Internal Revenue Code.

or otherwise, that their conduct had a "reasonable basis" and therefore complied with the requirements of § 530; they may be denied an opportunity to cross-examine government witnesses in order to demonstrate that they complied with the § 530 withholding statute; they may be refused any jury instructions that their compliance with the "reasonable basis" standard of § 530 would shield them from criminal tax culpability; and also denied jury instructions that the tax law concerning the classification of workers as independent contractors or employees was uncertain within the meaning of *James v. United States*. Petitioners here have even been denied their request that the jury simply be instructed as to the existence and content of §530 (136a-137a). As a final irony, by precluding the petitioners from advancing in this criminal case their contention that had they met the requirements of § 530, the Government may well have collaterally estopped them from arguing in a subsequent civil proceeding that § 530 eliminated their duty to withhold since the existence of such a duty is clearly an element of the crimes for which they have been convicted here. The government now seems to have found a way to circumvent completely the impact of § 530: simply prosecute a criminal case first and thereby insure an advantageous collateral estoppel position in any subsequent civil cases. *Cf. Gray v. Commissioner*, 708 F.2d 243 (6th Cir. 1983), *cert. denied*, 466 U.S. 927 (1984). As the district court indicated, the set of rulings on § 530 were in response to a " 'novel' " set of issues affecting "virtually every count of the indictment" (143a).

This Court should grant review of the decision below both to insure that employers who may have misclassified workers as independent contractors, rather than employees, will not be deprived of their constitutional rights to a fair trial and to halt immediately the potential contained in the decision below for creating chaos in the administration of both the employment tax and withholding provisions and unrelated penalty provisions of the federal tax law.

Conclusion

For these reasons, then, this Court should—and petitioners request that it does—issue its writ of certiorari to review the judgment of the court below.

Respectfully submitted,

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February 21, 1986

APPENDIX

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Court of Appeals Opinion

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 216, 217—August Term, 1985

(Argued September 18, 1985

Decided November 20, 1985)

Docket Nos. 85-1023, 1024

UNITED STATES OF AMERICA,

Appellee,

v.

RODERICK J. MACKENZIE, MALCOLM L. MACKENZIE, and DAVID H. MACKENZIE, INC.,

Appellants.

Before:

OAKES and NEWMAN, *Circuit Judges*, and POLLACK, *Senior District Judge*.*

Corporation, its president and general manager were convicted in the United States District Court for the District of Connecticut, Ellen Bree Burns, *Judge*, of various counts of conspiracy, false filing of tax returns,

* Of the Southern District of New York, sitting by designation.

and aiding and assisting false filing, all in connection with failure to withhold taxes from payments to workers, and they appeal. Held, where no reasonable doubt existed that their workers were employees rather than independent contractors, appellants' claim that the tax laws surrounding the question are void for vagueness was without merit; Section 530 of the Revenue Act of 1978 neither barred prosecution for failure to withhold nor required an instruction to the jury; the instructions on willfulness were proper; numerous rulings refusing to suppress evidence were correct; and the evidence was sufficient to convict on the one false filing count in which the sufficiency was challenged, and on the aiding and assisting counts.

Affirmed.

JACOB D. ZELDES, Bridgeport, CT (David P. Atkins, Zeldes, Needle & Cooper, Bridgeport, CT, of counsel), *for Appellants Roderick J. MacKenzie and David H. MacKenzie, Inc.*

ANDRE L. NAGY, Bridgeport, CT, *for Appellant Malcolm L. MacKenzie.*

ELLIOT R. WARREN, Assistant United States Attorney (Alan H. Nevas, United States Attorney for the District of Connecticut, of counsel; Allan Abare, Law Student Intern, on the brief), *for Appellee.*

OAKES, *Circuit Judge*:

This is an appeal from convictions for conspiracy to defraud the United States, filing fraudulent tax returns, and aiding and assisting the filing of fraudulent returns, all in connection with paying employees without withholding taxes. Appellants contend that the underlying withholding statute and regulations are unconstitutionally vague, that a provision of the Tax Reform Act of 1978 offers a "safe haven" defense that either barred this prosecution or should have been submitted to the jury; that the jury was improperly charged that deliberate ignorance would satisfy the requirement of knowledge; that the denial of their motions to suppress evidence obtained by virtue of civil summonses and other evidence obtained allegedly in violation of the plain view doctrine during a search executed pursuant to warrant were wrongly denied; and that the evidence regarding one false filing count and all of the aiding and assisting counts was insufficient. After a jury trial, appellants David H. MacKenzie, Inc., Roderick J. MacKenzie, and Malcolm MacKenzie were all convicted of conspiracy, 18 U.S.C. § 371 (1982); Roderick MacKenzie was convicted of eleven counts of false filing of Forms 941, employer's quarterly tax returns, 26 U.S.C. § 7206(1) (1982); and both MacKenzies were convicted of five counts of aiding and assisting the filing of employees' false tax returns, 26 U.S.C. § 7206(2) (1982). The United States District Court for the District of Connecticut, Ellen Bree Burns, Judge, sentenced the corporation to a $10,000 fine; Roderick MacKenzie to a $10,000 fine, three years' incarceration with all but thirty days suspended on the conspiracy count and one year's probation on each of the other counts, the sentences on all counts to be concurrent; and Malcolm

FACTS

Roderick MacKenzie was president and Malcolm general manager of the family painting company, David H. MacKenzie, Inc. During the tax years in question, 1976-1979, the corporation paid a number of its full-time painters, in addition to their usual salaries, straight time for overtime and holiday work rather than the time and one-half or double time required by the union contracts, although the union painters were paid an additional sum more or less equalling the amount which the union contract required an employer to pay to cover employee benefits and insurance. These payments were made off the books, by separate check, and separate records of them were kept. No income or social security taxes were withheld by the corporation from these overtime or holiday work payments, nor were the payments reported to the Internal Revenue Service. The company accountant was told that the company was using more independent contractors; the wages of these "independent contractors" were posted to a materials purchased account or, after the accountant became suspicious, to a labor purchase account on a ledger sheet which, along with the separate payroll records, was withheld from the IRS.

The alleged conspiracy also involved another scheme as to which the jury could properly have found that the company contracted with certain nonunion painters to do work under the name of the "MacKenzie Co." The MacKenzie to three years with all but six months suspended and two years' probation on the conspiracy count and on each of the aiding and assisting counts, all to run concurrently. We affirm.

MacKenzie Co. was headed by one Dennis McDevitt, a former self-employed subcontractor, who acted as supervisor of nonunion employees hired by the company. Disbursements for work performed by the nonunion painters employed by the MacKenzie Co. were not handled through the corporate accounting system. Rather, the nonunion painters were paid an hourly wage, in cash, by McDevitt, who received a check from David MacKenzie, Inc., for this purpose. The wages paid to the McDevitt nonunion painters were not reported to the IRS, nor were income taxes or social security taxes withheld. Only after it appeared that the IRS might discover the unreported payroll did the MacKenzies notify nonunion employees that they could, if they chose, go on the payroll. For those who did not so choose, appellants prepared Forms 1099, which must be filed if an independent contractor is paid $600 or more in a calendar year, *see* 26 U.S.C. § 6041(a) (1982), Treas. Reg. § 1.6041-1 (1985), for the first time for calendar year 1979, after the corporation had come under IRS investigation.

By underreporting the payroll to the IRS, the corporation avoided significant federal income and FICA (social security) taxes for calendar years 1976, 1977, 1978, and 1979. The five aiding and assisting counts related to three separate employees who falsified their returns by understating their income for various tax years during the period in question.

DISCUSSION

The concept of requiring withholding from wages of amounts to be applied against income tax liability in-

volves making employers tax collectors with respect to the forthcoming tax obligation of their employees. 8A J. Mertens, *The Law of Federal Income Taxation* § 47A.03, at 10 (1978). The existence of an employer-employee relationship is necessary for there to be any duty of withholding on the one hand or liability to be subjected to withholding on the other. Congress defined certain people as employees in 26 U.S.C. § 3401(c) (1982), and made clear the common law definition would govern who would be considered an employee. *See* 26 U.S.C. § 3121(d)(2) (1982). Treasury Regulation § 31.3401(c)-1(b) (1985) states specifically that the test is whether "the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished."[1] The factors mentioned in the regulations are among those that section 220 of the *Restatement (Second) of Agency* (1957) suggests for determining the existence of a master-servant relationship. It is obvious that in drawing the line between who is an employee and who is an independent contractor there will be some doubtful cases, a fact the regulations recognize in

---

1. The regulations continue:

> In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

Treas. Reg. § 31.3401(c)-1(b) (1985).

that, they say, a worker might be an employee under one statute but not the other. And they point to the statutory exceptions from the employment tax laws contained in, e.g., 26 U.S.C. § 3402(n) and 26 U.S.C. § 3121(b). The complexity of all these statutes and regulations, they argue, created endless confusion about what an employer's obligations were and in what circumstances they applied or did not apply. Finally, they argue that the Government has brought but one other criminal prosecution for willful misclassification of workers, *United States v. McLaughlin*, 663 F.2d 949 (9th Cir. 1981), and contend that even the Government is confused about what the law requires, noting that its counsel was unable to state at trial precisely when Dennis McDevitt ceased being an independent contractor and his painters became employees. The confusion surrounding the statutory requirements in question, appellants claim, makes it impossible for employers to know whether they are obeying the law, and creates the possibility of arbitrary enforcement, making a vagueness challenge appropriate. Appellants remind us that the Supreme Court has only recently reaffirmed acknowledging that whether the relationship exists will be determined "upon an examination of the particular facts of each case." Treas. Reg. § 31.3401(c)-1(d) (1985).

It is from the fact that there are doubtful cases that appellants seek to make their strongest arguments. They point out that over the years decisions about whether a person is an employee or an independent contractor have been "inconsistent and unpredictable," and they cite examples. They point out that the statutory employees described in 26 U.S.C. § 3121(d) and Treasury Regulation § 31.3121(d)-1(d) (pertaining to FICA) are not discussed under 26 U.S.C. § 3401 (pertaining to income tax) so

the void-for-vagueness doctrine, requiring "that a penal statute define the criminal offense with sufficient definiteness that ordinary people can understand what conduct is prohibited and in a manner that does not encourage arbitrary and discriminatory enforcement." *Kolender v. Lawson*, 461 U.S. 352, 357 (1983).

Moreover, they claim, Congress acknowledged that the law in the area was hopelessly confused when it enacted Section 530 of the Tax Reform Act of 1978, reading in pertinent part as follows:

> (a) Termination of Certain Employment Tax Liability for Periods Before 1980.—
>
> (1) In General.—If—
>
> (A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
>
> (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,
>
> then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.
>
> (2) Statutory Standards Providing One Method of Satisfying the Requirements of Paragraph (1).—For purposes of paragraph (1), a taxpayer shall in any

case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

> (A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;
>
> (B) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or
>
> (C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

(3) Consistency Required in the Case of Prior Tax Treatment.—Paragraph (1) shall not apply with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for any period beginning after December 31, 1977.

Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86 (codified at 26 U.S.C. § 3401 note (1982) (as amended)). Appellants particularly refer us to the purpose of the adoption of that section:

> The agreement terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis

> for treating workers other than as employees and who file all required federal tax returns for periods after December 31, 1978; (2) extends relief prospectively through 1979 for taxpayers having a reasonable basis for their classification of workers; and (3) prohibits the issuance of regulations and Revenue Rulings on common law employment status before 1980.

H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 271, *reprinted in* 1978 U.S. Code Cong. & Ad. News 7198, 7266, and to *Ridgewell's, Inc. v. United States*, 655 F.2d 1098 (Ct. Cl. 1981), where the United States Court of Claims said:

> As the section title indicates, section 530 was aimed at controversies between taxpayers and the IRS as to whether certain individuals had the status of employees of the taxpayers. In the late 1960's, the IRS increased its enforcement of the employment tax laws. This led to many controversies with taxpayers when IRS proposed to reclassify individuals from independent contractor status to employee status and the taxpayers complained that the reclassifications involved changes in IRS's position on how the common law rules applied to particular individuals. During the 1976 Tax Reform Act conference, House and Senate conferees requested that IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the Joint Committee on Taxation had a chance to study the problem. Congress then went further by enacting section 530 wherein interim relief was provided to taxpayers involved in such

> controversies so that Congress would have more time to formulate a comprehensive solution.

Id. at 1101.

We agree that there are doubtful cases and doubtless Congress, when it adopted section 530, intended to protect from civil liability those who reasonably made a determination that a given individual was an independent contractor rather than an employee. But this is not to say that there was any doubt—much less a reasonable one—in this case. First, as to the union painters who were paid, without withholding, for overtime and holiday work, it is clear that they were employees, since they were paid as such—with withholding done—for their regular weekly hours, and no separate arrangements were made for their overtime work. Starting in late 1975, they simply began to be paid off the payroll without withholding for weekend and holiday work, an arrangement that they were obviously asked to accept because it enabled the company to save money and which they accepted because they themselves were getting approximately the same net as they would on union scale after withholding. While the company's accountant was told that the company was using independent contractors, he was not told that these in fact were regular employees, nor was he consulted as to the separate payroll sheets or the absence of W-2 or 1099 forms. Indeed, some workers requested and received permission to be paid off the books not only for overtime but for certain regular working hours, a request that resulted in two or three of them being prosecuted (along with the MacKenzies) for falsifying their own returns, as to which Malcolm and Roderick were held to have aided and assisted. That appellants were well aware that these payments were inappropriate, not to say downright ille-

gal, was clear from the fact that the payments were recorded on separate books, concealed from the company's own accountant, and (in 1979) made in cash or by separate checks made payable to "Cash" rather than to painters by name.

While the case was not as crystal clear, perhaps, as to the nonunion workers who had been employed by Dennis McDevitt in the MacKenzie Co., the case for the Government was nevertheless a strong one. Malcolm directed McDevitt to hire specific workers and overruled McDevitt to grant raises to workers. Both Malcolm and Roderick verified to financial institutions that McDevitt and some of his men were employees of the corporation. They also kept track of the earnings of the nonunion painters. Through the period of operation McDevitt received a gross payroll check for all nonunion workers and distributed the money in cash; no withholding was done. Only when McDevitt, who had not filed personal income tax returns, was told by his new wife in 1979 that she was going to file a return, did Malcolm put McDevitt, and later the nonunion workers, directly on the MacKenzie Co. payroll. With respect to neither group of workers did appellants, until late 1979 or early 1980, prepare the 1099 forms consistent with the "independent contractor" status they allegedly thought their workers had.

Generally speaking, a challenge to the tax laws on vagueness grounds must be specific rather than facial. *See United States v. Mazurie*, 419 U.S. 544, 550 (1975) ("vagueness challenges to statutes which do not involve First Amendment freedoms must be examined in the light of the facts of the case at hand"); *see generally* Note, *The Void-for-Vagueness Doctrine in the Supreme Court*, 109 U. Pa. L. Rev. 67 (1960). That the statute and regulations

may present some doubtful cases does not mean that they are void for vagueness where the particular case at hand is not doubtful. As held in *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926),

> [T]he decisions of the court upholding statutes as sufficiently certain, rested upon the conclusion that they employed words or phrases having a technical or other special meaning, well enough known to enable those within their reach to correctly apply them, or a well-settled common law meaning, notwithstanding an element of degree in the definition as to which estimates might differ.

(Citations omitted.) In this case the statutes as amplified by the Treasury Regulations comprehensively define "employee" and "wages" and specifically refer to the common law use of those terms. Hypothetical situations are irrelevant. *United States v. Irwin*, 354 F.2d 192, 196 (2d Cir. 1965), *cert. denied*, 383 U.S. 967 (1966). Appellants here fail to state any plausible claim that, as applied to them, the statute and regulations here were impermissibly vague.

Moreover, the requirement of willfulness in the criminal tax laws has a bearing on an analysis of vagueness. As the Supreme Court said in *United States v. Ragen*, 314 U.S. 513, 524 (1942): "On no construction can the statutory provisions here involved become a trap for those who act in good faith. A mind intent upon willful evasion is inconsistent with surprised innocence." *See also United States v. Bishop*, 412 U.S. 346, 360-61 (1973).

Nor do appellants gain by the enactment of section 530. The enactment of that statute does not disclose any intent

to preclude criminal prosecutions of violations of the withholding laws; the silence of the congressional history in this regard is significant. *See* L. Tribe, *Constitutional Choices* 41-42 (1985). We agree essentially with the United States Court of Claims' summary of the history of the passage of section 530 set forth in *Ridgewell's, Inc.*, 655 F.2d at 1101, as quoted *supra*. The point of the section, as the Government's brief points out, is that in the area of withholding requirements a good faith taxpayer who was determined to have made an honest mistake might be liable for enormous sums that should have been withheld from employees' paychecks but were instead paid to the workers. Thus a limited "safe haven" was set up for those employers who manifested a "reasonable basis" for their treatment of employees as independent contractors. But as stated in the Senate report, not every employer can qualify for the safe haven; "a taxpayer will not be considered to have acted in good faith if his treatment of individuals as independent contractors would, on the basis of the pertinent facts and circumstances, constitute negligence, intentional disregard of rules and regulations, or fraud within the meaning of section 6653 of the Code." S. Rep. No. 1263, 95th Cong., 2d Sess. 211, *reprinted in* 1978 U.S. Code Cong. & Ad. News 6761, 6974. Thus, Congress did not intend an absolute safe haven in section 530 even with respect to civil liability and could hardly have intended to abate criminal prosecutions where there is not only a lack of good faith but also deliberate tax evasion with concealed records and with intent to defraud. We note that the suggestion that section 530 provided a defense in a prosecution for failure to withhold has been rejected. *United States v. McLaughlin*, 663 F.2d at 952.

Perhaps appellants' strongest argument, and certainly an argument very carefully considered by the district court, was that they were at least entitled to an instruction under section 530 that would require the jury to apply the factors outlined in the "safe haven" law. Such instructions were duly requested. We agree with the district court's conclusion that no section 530 instruction was needed; the requirement of specific intent in this crime negates the availability of a section 530 defense. The appellants argue that such an interpretation does away with the *actus reus* requirement for the offense, *see United States v. Muzii*, 676 F.2d 919, 920 (2d Cir.) (*mens rea* alone insufficient to impose criminal sanction; *actus reus* also required), *cert. denied*, 459 U.S. 863 (1982), and that if their conduct was objectively "reasonable," it would be improper to prosecute them even if subjectively they knew their conduct violated the statute. It seems more correct, however, to say that there is always an *actus reus* when employers fail to withhold, but that the "safe haven" law in effect deems that where an employer acts in a reasonable manner without knowledge that he is violating the law, he does not have *mens rea*.

In any event, the context of section 530 is civil. As we have previously pointed out, Congress was concerned that employers acting reasonably and without intent to violate the law not be hit with heavy civil penalties. It surely intended no safe haven for bad faith or fraudulent employers. Moreover, the failure to file 1099s in this case would seem to negate any likelihood that appellants were acting "consistently" in treating their workers as independent contractors; they are, therefore, not among the employers that Congress intended to protect. *See* S. Rep.

No. 1263 at 210, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 6973.

Nor was there in this case any colorable evidence of reasonable reliance on the part of the appellants. The appellants claim this case is like *United States v. Critzer*, 498 F.2d 1160, 1162 (4th Cir. 1974), where the court reversed a conviction for income tax evasion despite the fact that a jury had concluded that defendant had intended to violate her obligations under the Tax Code. To the court it was not clear that she was subject to taxation. *Critzer* was cited favorably in *United States v. Garber*, 607 F.2d 92, 98-99 (5th Cir. 1979) (en banc) (defendant's actual intent is irrelevant when the law is so uncertain). We rejected the reasoning of *Garber* in *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 96-97 (2d Cir.), *cert. denied*, 462 U.S. 1131 (1983), because the inevitable logic of the decision requires that if the tax laws are uncertain an indictment should be dismissed, regardless whether the taxpayer acted in good faith. *Id.* at 97. We found in *Ingredient Technology* that there was no evidence that the principal individual defendant or anyone else employed by the corporate defendant genuinely thought that what he was doing was lawful and proper; rather, the conduct of the individuals indicated a subjective belief in the unlawfulness of the conduct. The same is true here. This is not to say that if the requirements in issue under the Tax Code are so muddled that the taxpayer is genuinely uncertain about their applicability, *Critzer* would not be persuasive. But no such uncertainty is involved on the facts of this case.

We nevertheless insisted in *Ingredient Technology* that the court's instructions concerning willfulness be proper. *Id.* Here the instruction on willfulness is questioned. The

instruction as given is set forth in the margin.[2] We note parenthetically that it is essentially in the language of the pattern instruction given in 1 E. Devitt & C. Blackmar, *Federal Jury Practice and Instructions* § 14.09 (3d ed. 1977), except that the last two sentences elaborate upon the last sentence of the pattern instruction, to the defendants' advantage. Indeed, the court specifically charged that the adage that ignorance of the law is no excuse did *not* apply because Roderick MacKenzie could be convicted only "if he acted with the deliberate intent to avoid that which he knew the law required him to do." Moreover, the jury was charged that he did not need to have "actually investigated the law to determine his duty." But appellants claim that in a tax case a deliberate ignorance instruction dilutes the applicable knowledge standard, arguing that *United States v. Pomponio*, 429 U.S. 10, 12 (1976) (per curiam), and *United States v. Bishop*, 412 U.S. at 360, require affirmative proof of a defendant's actual knowledge of the existence and applicability of identifiable Tax Code obligations, a requirement that is negated by the guilty knowledge charge as given in this case. In effect, appellants argue, the charge constituted a dramatic shifting of the burden of proof within *Francis v.*

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2. The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what would otherwise have been obvious to him. A finding beyond a reasonable doubt of a conscious purpose to avoid enlightenment would permit an inference of knowledge. Stated another way, a defendant's knowledge of a fact may be inferred from willful blindness to the existence of the fact.

It is entirely up to you as to whether you find any deliberate closing of the eyes and the inferences to be drawn from any such evidence. Although knowledge may be inferred from the defendant's behavior, you must still find that he had actual knowledge. However, a showing of mistake, negligence, carelessness, recklessness, or even gross negligence is not sufficient to support a finding of either willfulness or knowledge.

Franklin, 53 U.S.L.W. 4495, 4498 (U.S. Apr. 29, 1985), and *Sandstrom v. Montana*, 442 U.S. 510, 524 (1979). Appellants claim that decisions supporting a conscious avoidance charge involve defendants' knowledge of facts, not of law. Thus, appellants argue, the jury must make a preliminary determination of the degree of awareness possessed by the taxpayer as to his legal obligations with respect to a return; only actual knowledge of the precise dictates of the law is adequate, citing *United States v. Brooksby*, 668 F.2d 1102, 1104-05 (9th Cir. 1982).

But the tax statute standard set forth in *Bishop*, 412 U.S. at 360 (" 'willfully' in these statutes generally connotes a voluntary, intentional violation of a known legal duty"), is designed to separate the purposeful violator from the "well-meaning, but easily confused, mass of taxpayers," *id.* at 361, to avoid penalizing " 'innocent errors made despite the exercise of reasonable care.' " *Id.* at 360-61 (quoting *Spies v. United States*, 317 U.S. 492, 496 (1943)). Here the charge clearly informed the jury that actual knowledge was required and that recklessness was not adequate to prove willfulness. It eliminated no elements of the offense. *Cf. Brooksby*, 668 F.2d at 1104-05 (failure to instruct that willfulness was an essential element of crime prejudiced defendant). While the appellants argue that the trial court itself confused the concepts of knowledge of both facts and law, we think the opposite is the case. The deliberate ignorance instruction included a reference to "willful blindness to the existence of the fact," which as applied here would simply mean that the MacKenzies could not ignore the fact that their employees were employees and not independent contractors. By saying that the adage that ignorance of the law is no excuse was *not* applicable, the court clearly met the

requirements of *Pomponio* and *Bishop* by making clear to the jury that knowledge of the law was distinct from knowledge of facts. Such knowledge of the law was inferable and proven from the fact that appellants did indeed pay withholding on behalf of the union employees during their regular work weeks. Defendants' backgrounds (each had a college degree, Roderick in economics and Malcolm in business) also demonstrate the likelihood they knew what the law required.

Francis and *Sandstrom*, the burden-of-proof-shifting cases, are also clearly inapposite, since they involved presumptions, while the instruction here merely created a permissive inference. That the instruction as given was called for on the facts of this case is clear from the defense claims: that Malcolm MacKenzie did not know that the separate check payments were wages rather than payments to independent contractors, but merely assumed that when he did not withhold taxes, the recipient of such money automatically became an independent contractor; and that the MacKenzies did not know the separate payroll registers kept by the company bookkeeper existed, much less that they were being concealed from the firm's accountant and the IRS.

Appellants argue that the court improperly denied their pretrial motion to suppress evidence obtained through IRS civil summonses under 26 U.S.C. § 7602 (1982), because the summonses were issued after an institutional decision was made, on April 11, 1980, to abandon civil sanctions in favor of criminal prosecution and because the IRS delayed referral of the case to the Justice Department for prosecution so as to be able to gather additional evidence, all of which was in violation of *United States v. LaSalle National Bank*, 437 U.S. 298 (1978). *United*

States v. Powell, 379 U.S. 48, 57-58 (1964), held that the IRS "must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed . . . ," *quoted in LaSalle*, 437 U.S. at 313-14. While it is not improper for the IRS to issue a civil summons when it is also considering a criminal prosecution, unless it is issued after the IRS has recommended to the Justice Department initiation of a criminal prosecution, *LaSalle* does allow for a limited inquiry into IRS "good faith" even if the summonses were issued before a criminal recommendation. In making such an inquiry a court is required, however, to look at the "institutional" posture of the IRS rather than that of an individual agent, *LaSalle*, 437 U.S. at 316. In this respect appellants argue that by letting the civil statute of limitations run as to liability for false filing of Forms 941 for the quarters ending in calendar year 1976, the IRS had abandoned its civil purpose. A memorandum dated April 11, 1980, from group managers of the IRS Examination Group and Criminal Investigation Division to their respective Chiefs pointed out that these returns were "presently the subject of a joint criminal investigation," that "a decision must be made to either let the statute expire or assess the tax," and that the case had been "developed to the point where the Criminal Investigation Division is of the strong opinion that there appears to be a viable fraud case" which would be jeopardized by the assessment of the tax for 1976. Nevertheless, a search warrant dated April 28, 1980, demanded 1976 materials. Appellants argue this clearly demonstrated that the Service was collecting further information for use in the criminal case.

But at the time of the April 11, 1980, memorandum, which was, after all, only a recommendation, the decision to prosecute appellants had only gone to the District Director; the Regional Counsel's office had not approved the bringing of criminal charges, as required by 26 C.F.R. § 601.107 (1985). At any time the Service could have forgone the criminal action and sought civil penalties. The April 11, 1980, memorandum itself noted that recourse might be had to employees and that the big liability was for later years so that not much would be lost by forgoing the civil claim for 1976. Appellants bore the burden of showing *no* valid civil purpose. *See LaSalle*, 437 U.S. at 316; *United States v. First National State Bank*, 616 F.2d 668, 672 (3d Cir.), *cert. denied*, 447 U.S. 905 (1980). The district court's determination that they failed to meet that burden is not clearly erroneous. Nor does the obtaining and execution of search warrants cause the investigation to become solely criminal or demonstrate bad faith by the IRS. *United States v. First National Bank*, 628 F.2d 871, 874 (5th Cir. 1980); *United States v. Zack*, 521 F.2d 1366, 1369 (9th Cir. 1975).

Appellants contend that under 26 U.S.C. § 7609 (1982), they should have been given notice when their bank was summonsed to disclose whether any of appellants had accounts with the bank and, if so, what kind. The statute requires notice for any "production . . . of records" by third-party recordkeepers, 26 U.S.C. § 7609(a)(1)(B), but does not require it if the summons only asks whether records have been made or kept. 26 U.S.C. § 7609(a)(4)(B). This case does not seem to fall clearly into either subparagraph (1)(B) or (4)(B), but legislative history suggests (though not, perhaps, with pristine clarity) that this summons is included in the § 7609(a)(4)(B) exception:

> However, this procedure [the requirement of notice] will not apply in the case of a summons used solely for purposes of collection. Also, this procedure would not apply in cases where the only information requested by the Service was whether or not the third-party record keeper had records with respect to a particular person (without requesting any information contained in those records).
>
> Thus, where the Service has made an assessment or obtaining [sic] a judgment against a taxpayer and serves a summons on a bank, for example, in order to determine whether the taxpayer has an account in that bank, and whether the assets in that account are sufficient to cover the tax liability which has been assessed, the Service is not required, under the committee amendment, to give notice to the taxpayer whose account is involved.

S. Rep. No. 938, 94th Cong., 2d Sess. 371, *reprinted in* 1976 U.S. Code Cong. & Ad. News 3439, 3800-01.

Appellants claim that a 1979 payroll book was improperly examined during the execution of a search warrant. Their claim that it could not properly be examined under the plain view doctrine, *Coolidge v. New Hampshire*, 403 U.S. 443, 464-73 (1971), because the IRS already expected to find it is not persuasive. The book was not seized. The IRS agent conducting the search testified she looked at it briefly to see if it fell within the warrant, and replaced it. The district court credited that testimony, and in general was impressed with the agents' conduct. Appellants argue that this perusal led to the summons of the document later, thereby tainting that summons, making it, they claim, "the fruit of the earlier illegal search." Brief for

Appellants at 59. However, appellants concede the agents knew that the document existed before summoning it. It is hard to see what right was invaded when the agent looked at the book.

Roderick MacKenzie claims that the evidence is insufficient to convict him of willful wrongdoing in filing the last quarterly Form 941. MacKenzie alleged he followed the advice of his lawyer, who told him to do exactly what he had been doing. While this may be a defense, *Bursten v. United States*, 395 F.2d 976, 981 (5th Cir. 1968), apparently the jury here either did not believe that MacKenzie was given this advice or found that he made misrepresentations to his lawyer or failed to make disclosures when he obtained the advice and was therefore not entitled to rely on it. In either case there is no reason to overturn that assessment.

Both the individual appellants challenge the sufficiency of evidence to show they issued false W-2 forms to three workers to aid them in filing their own false tax returns. While appellants had nothing to do with the preparation of the tax returns of the employees in question, they knew the returns would be fraudulently filed and relied on that fact to conceal their ongoing fraud. In the cases the Government cites for non-preparer liability, the defendants played more active roles, *e.g.*, *United States v. Wolfson*, 573 F.2d 216, 218 (5th Cir. 1978) (defendant, a marine surveyor, solicited charitable donations of yachts and appraised them over their value); *United States v. Haimowitz*, 404 F.2d 38, 39-40 (2d Cir. 1968) (defendant had others cash in his race track winnings and told them to tell the IRS that they were compulsive gamblers); *United States v. Maius*, 378 F.2d 716, 718 (6th Cir.) (defendant was bookkeeper and did banking business for

corporation), *cert. denied*, 389 U.S. 905 (1967), but were similar in that the defendants profited by enabling another to file fraudulent returns. On balance, we believe the aid and assist convictions must stand.

Judgment affirmed.

Court of Appeals Order on Petition for Rehearing

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

85-1023, -1024

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 21st day of January, one thousand nine hundred and eighty-six.

UNITED STATES OF AMERICA,

Appellee,

v.

RODERICK J. MACKENZIE, MALCOLM L. MACKENZIE, and DAVID H. MACKENZIE, INC.,

Appellants.

ORDER ON PETITION FOR REHEARING

On November 20, 1985, this court issued an opinion affirming the convictions of all the petitioners for conspiracy and of the individual petitioners, one for false filing of tax returns and both for aiding and assisting the filing of false returns. Petitioners seek a rehearing of their appeal. We deny the petition; however, it raises some serious issues we think it appropriate to clarify.

Petitiners assert, inter alia, that the court relied improperly on S. Rep. No. 1263, 95th Cong., 2d Sess., *reprinted in* 1978 U.S. Code Cong. & Ad. News 6761, in rejecting their claim

that section 530 of the Revenue Act of 1978 barred their prosecution or at least entitled them to a jury instruction that if they had a reasonable basis for believing that their conduct was within the law, they should be acquitted. Petitioners object to reliance on the Senate report because that report referred to a version of the statute not ultimately enacted, which required a taxpayer taking advantage of section 530 to act in "good faith." But section 530 as ultimately enacted refers to "reasonable basis" rather than "good faith"; this represents, they argue, a completely different standard that precludes consideration of the taxpayer's subjective state of mind. Using the "good faith" language that appears in the Senate report to require that the taxpayer act in good faith would, they argue, fundamentally change the intent of the statute.

We have considered and reject petitioner's contention that reliance on the Senate report was improper. We hold the Government's arguments on this issue persuasive. The Government points out, first, that the intention of the two houses of Congress in passing the bill was the same. *Compare* H.R. Rep. No. 1748, 95th Cong., 2d Sess. 3-4 (1978), *with* S. Rep. No. 1263 at 209-10, 1978 U.S. Code Cong. & Ad. News at 6972-73 (substantially identical language describing purposes of statute).

Second, the conference committee report on the statute, H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 271, *reprinted in* 1978 U.S. Code Cong. & Ad. News 7198, 7266, states that the conference agreement was "substantially the same as the Senate amendment. However, for technical reasons, the agreement generally follows the text of H.R. 14159 . . . ." Had the removal of the "good faith" language made a significant change in the statute, as petitioners contend, it seems unlikely that the conference committee would refer to the changed bill as "substantially the same" or deem the change "technical." And, while one court has refused to rely on the Senate report, *see Ridgewell's, Inc. v. United States*, 655 F.2d 1098, 1104 (Ct. Cl. 1981), it did so in an instance where the Senate's version of the statute differed from the enacted one meaningfully (if

"technically") by requiring filing of returns (Forms 1099) in years where the statute as enacted did not.

Petitioners correctly assert that under section 530(a)(1)(B), their failure to file Forms 1099 before December 31, 1978, did not bar them from taking advantage of section 530, and they are right that the failure to file Forms 1099 did not breach the "consistency" requirement of the statute, notwithstanding the suggestion to the contrary made in our opinion. However, it was appropriate for the court to consider the failure to file Forms 1099 as belying petitioners' assertions that they reasonably believed the employees in question to be independent contractors.

Petition denied.

/s/ James L. Oakes

/s/ Jon O. Newman

Circuit Judges.

/s/ Milton Pollack

District Judge.

House Version of § 530

95th Congress
2d Session

H.R. 14159

Mr. Rangel (for himself, Mr Jones of Oklahoma, Ms. Keys, Mr. Holland, Mr. Gephardt, Mr. Crane, and Mr Bafalis)

A BILL

Relating to the interim treatment of controversies involving whether certain individuals are employees for purposes of the employment taxes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. TERMINATION OF CERTAIN EMPLOYMENT TAX LIABILITY FOR PERIODS BEFORE 1980.

(a) In General.—If, for purposes of the employment taxes, the taxpayer did not treat an individual as an employee for any period ending before January 1, 1980, then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

(b) Statutory Standards Providing One Method of Satisfying the Requirements of Subsection (a).—For purposes of subsection (a), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if—

(1) all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period were filed on a basis

consistent with the taxpayer's treatment of such individual as not being an employee, and

(2) the taxpayer's treatment of such individual for such period was in reasonable reliance of any of the following:

(A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(B) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or

(C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

(c) Consistency Required in the Case of 1979 Tax Treatment.—Subsection (a) shall not apply with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for any period beginning after December 31, 1977.

(d) Refund or Credit of Overpayment.—If refund or credit of any overpayment of an employment tax resulting from the application of subsection (a) is not barred on the date of the enactment of this Act by any law or rule of law, the period for filing a claim for refund or credit of such overpayment (to the extent attributable to the application of subsection (a)) shall not expire before the date 1 year after the date of the enactment of this Act.

SEC. 2. PROHIBITION AGAINST REGULATIONS AND RULINGS ON EMPLOYMENT STATUS.

No regulation or Revenue Ruling shall be published on or after the date of the enactment of this Act and before January

1, 1980 (or, if earlier, the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment taxes) by the Department of the Treasury (including the Internal Revenue Service) with respect to the employment status of any individual for purposes of the employment taxes.

SEC. 3. DEFINITIONS.

For purposes of this Act—

(1) Employment tax.—The term "employment tax" means any tax imposed by subtitle C of the Internal Revenue Code of 1954.

(2) Employment status.—The term "employment status" means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee).

Ways And Means Committee Report,
October 10, 1978 (Excerpted)

HOUSE OF REPRESENTATIVES

95TH CONGRESS—*2d Session* REPORT—No. 95-1748

CONTROVERSIES INVOLVING THE EMPLOYMENT STATUS OF CERTAIN INDIVIDUALS FOR PURPOSES OF THE EMPLOYMENT TAXES

OCTOBER 10, 1978.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ULLMAN, from the Committee on Ways and Means, submitted the following

REPORT

together with

DISSENTING VIEWS

[To accompany H.R. 14159]

The Committee on Ways and Means, to whom was referred the bill (H.R. 14159) relating to the interim treatment of controversies involving whether certain individuals are employees for purposes of the employment taxes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY

The bill provides interim relief from employment tax liability to taxpayers involved in employment tax status controversies. Eligible taxpayers are relieved of all liability for Federal income tax withholding, social security (FICA) taxes, and unem-

ployment (FUTA) taxes with respect to their workers for any period ending before January 1, 1979, provided the taxpayers had a reasonable basis for not treating the workers as employees.

In order to minimize taxpayers' uncertainty about the proper treatment of workers for employment tax purposes during 1979, when the Committee on Ways and Means intends to work to develop a comprehensive, permanent solution to these controversies, the bill also relieves taxpayers prospectively through December 31, 1979, of potential liabilities based on employment status classifications, unless the taxpayers have no reasonable basis for not treating the workers as employees.

In addition, the bill prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling with respect to individuals' employment tax status after enactment of this legislation and before January 1, 1980, or the effective date of any legislation clarifying the employment tax status of individuals, whichever is earlier.

II. General Statement

Present law

With certain limited statutory exceptions, the classification of particular workers or classes of workers as employees or independent contractors (self-employed persons) for purposes of Federal employment taxes must be made under common law rules. A determination of an employer-employee relationship is important because a certain amount of wages paid to employees generally is subject to social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). On the other hand, payments to independent contractors are subject to the tax on self-employment income (SECA). In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

Generally, the basis for determining whether a particular worker is an employee or an independent contractor is the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee is deemed to exist. On the other hand, the absence of a right to control generally indicates that the person performing the services is an independent contractor. In interpreting the Treasury regulations, twenty factors are used in determining whether workers are employees or independent contractors.

Reasons for change

In the late 1960s, the Internal Revenue Service increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification, the taxpayer became liable for employment taxes—withholding, social security, and unemployment—which neither had been withheld nor paid to the Treasury.

In some cases, the assessments were for liabilities already paid directly by workers, who paid their own income and self-employment taxes. The IRS has agreed to allow taxpayers certain income tax and FICA-SECA offsets, if they provide the Service with their workers' names and social security numbers. However, many taxpayers lack such information about their workers and cannot benefit from this procedure.

Many taxpayers have complained that proposed reclassifications involve a change of position by the Internal Revenue Service in interpreting how the common law rules apply to their workers or industry. Some taxpayers have prior private letter rulings or technical advice memoranda from the Service

in which the Service held that the workers were independent contractors. Other taxpayers have pointed to prior audits in which their treatment of workers as independent contractors was not challenged. Before the 1970s, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published Revenue Rulings.

During the 1976 Tax Reform Act conference, House and Senate conferees included in the Statement of Managers a request that the IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying individuals as employees or independent contractors.

The committee believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassfications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area. The committee intends to undertake full consideration of the issues underlying these controversies next year in order to formulate a proposal for a comprehensive solution.

Explanation of provisions

In general

The bill provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees under interpretations of the common law by—

(1) terminating certain employment tax liabilities for periods ending before January 1, 1979,

(2) allowing taxpayers, who had a reasonable basis for not treating workers as employees in the past, to continue

such treatment without incurring employment tax liabilities for periods ending before January 1, 1980, while the committee works on a comprehensive solution, and

(3) prohibiting the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.

1. Termination of certain pre-1979 employment tax liability

The bill provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassification of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees. For purposes of determining such taxpayers' employment tax liabilities, the bill provides that workers shall be deemed not to be the taxpayers' employees, unless the taxpayers had no reasonable basis for not treating the workers as employees.

Liabilities terminated under the bill are those for Federal income tax withholding, social security (FICA), and unemployment (FUTA) taxes for any period ending before January 1, 1979, during which the taxpayers did not treat the workers as employees.

Generally, the bill grants relief if a taxpayer had any reasonable basis for treating workers as other than employees. The committee intends that this reasonable basis requirement be construed liberally in favor of taxpayers.

In addition, the bill establishes several alternative statutory standards which constitute "safe havens," and thus, when met, qualify a taxpayer for the termination of employment tax liability. The bill provides that a taxpayer shall be treated as having had a reasonable basis for not treating an individual as an employee for a period if (1) the taxpayer filed all required Federal tax returns (including information returns) with respect to such individual on a basis consistent with the treatment of the individual as other than an employee, and (2) the taxpayer

can demonstrate that he fulfilled one or more of three statutory "reasonable basis" tests.

The first statutory reasonable basis standard is met if a taxpayer's treatment of an individual as not being an employee for a period was due to reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling (for example, a "letter ruling," or a "determination letter") issued to the taxpayer. Under this test, the precedent or published ruling upon which a taxpayer reasonably relied does not have to relate, necessarily, to the particular industry or business in which the taxpayer is engaged.

Under the second statutory "safe haven" standard, a taxpayer shall be treated as satisfying the reasonable basis test for the treatment of an individual for employment tax purposes, by showing reasonable reliance on a past Internal Revenue Service audit of the taxpayer. Such an audit need not have been for employment tax purposes. However, a prior audit would qualify as a "safe haven" basis for a taxpayer's reliance only if the audit entailed no assessment attributable to the taxpayer's treatment (for employment tax purposes) of indiviudals holding positions substantially similar to the postion held by the individual whose treatment is at issue. A taxpayer does not meet this second test if, in the conduct of a prior audit, an assessment attributable to the taxpayer's treatment of an individual was offset by other claims asserted by the taxpayer.

The third statutory method for a taxpayer to establish a reasonable basis for the treatment of an individual as other than an employee is to show that such treatment coincided with a long-standing, recognized practice of a significant segment of the industry in which the individual whose status is at issue was engaged. This test does not require that a practice be uniform throughout an entire industry.

The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as other than an employee are not the exclusive ways of meeting the bill's reasonable basis requirement. A taxpayer

who can demonstrate a reasonable basis for the treatment of an individual in some other manner also is entitled to termination of employment tax liabilities.

Termination of employment tax liabilities under the bill is made available to taxpayers who are under audit by the Internal Revenue Service or who are involved in administrative or judicial processes with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or for a credit of any overpayment of an employment tax resulting from the proposal's termination of liability, provided the claim is not barred on the bill's date of enactment by any law or rule of law.

Taxpayers who have entered into final closing agreements under Code section 7121 or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the bill, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed or compromised a liability for an amount which is to be paid in installments, but who still has one or more installments to pay, is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Internal Revenue Service or who unsuccessfully litigated such cases are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, an unsuccessful litigant in an employment status case who fulfills the bill's requirements, can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

2. Employment tax liability for 1979

Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers under common law interpretations. Therefore, the bill allows taxpayers to continue to treat workers as other than employees through 1979, unless the taxpayers have no reasonable basis for not

treating the workers as employees. Thus, the bill prospectively relieves taxpayers of liabilities which they might incur next year.

Taxpayers' eligibility for the prospective relief from 1979 liabilities is to be determined under the same tests and the same liberal interpretations of the tests which determine eligibility for pre-1979 relief.

It is expected that legislation developed during 1979 to clarify the employment tax status of individuals would become effective January 1, 1980, or the date of enactment of the clarifying legislation, whichever is earlier, and would replace present law for all periods hereafter.

3. Anti-abuse provision

To prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions, the bill denies relief in such circumstances. The bill prohibits the termination of any potential employment tax liability with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor) has treated an individual holding a substantially similar position as an employee for any period beginning after December 31, 1977. The application of this provision to taxpayers and their predecessors is intended to prevent evasion of this rule, for example, by reincorporations.

4. Refunds or credits of overpayments

The bill allows taxpayers at least a one-year period for filing claims for refunds or credits attributable to the relief provided in the bill. If a taxpayer's claim for refund or credit is not barred on the bill's date of enactment by any law or rule of law, the taxpayer will have at least until the date one year after the bill's date of enactment for filing a claim. If the taxpayer is entitled to a longer period under the general statute of limitations for filing such claims, the longer period will apply.

Generally, taxpayers should file refund or credit claims asserting grounds for relief under the bill with the Internal Revenue Service. If the taxpayer already has an open claim filed with the Service, or is involved in litigation over such a claim with the Department of Justice, the original claim shall qualify as a claim for relief under this bill, provided the taxpayer notifies either the Service or the Department of Justice, whichever is appropriate, within the proper time period, of the taxpayer's basis for relying on the bill for relief.

5. Penalties and interest

If a taxpayer is relieved of liability for any tax under this bill, any liability for interest or penalties attributable to such tax liability is forgiven automatically. This relief will apply to all such interest and penalties for both pre-1979 and 1979 liabilities, whether charged directly against the taxpayer or personally against the taxpayer's officers.

6. Status, liabilities and rights of individual employees and independent contractors

The bill does not change in any way the status, liabilities, and rights of an individual whose employment status is at issue.

7. Prohibition against IRS Revenue Rulings and Regulations

In addition, the bill prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling classifying individuals for purposes of employment taxes under interpretations of the common law. This prohibition becomes effective on the date of enactment of the bill and remains in effect until January 1, 1980, or, if earlier, the effective date of any law subsequently enacted to clarify the employment status of individuals for purposes of employment taxes.

The prohibition applies to Revenue Rulings having precedential status but does not apply to the issuance of private letter

rulings requested by taxpayers. Moreover, the prohibition does not extend to regulations or Revenue Rulings based on statutory provisions dealing with the employment tax status of particular workers, such as certain fishermen, which do not involve the application of common law standards; nor does the prohibition apply to the determination of matters such as effective dates, which do not entail issues of common law employment status for purposes of employment taxes.

Effective date

The provisions of the bill are effective upon enactment.

Revenue effect

The revenue effect of the provisions of the bill cannot be estimated because the provision affects IRS-asserted employment tax liabilities which are being contested by taxpayers in both administrative and judicial proceedings.

III. Effect of the Bill On the Budget and Vote of the Committee In Reporting the Bill

Budget effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 14159. The committee states that the revenue effect of this bill cannot be estimated because the provision affects IRS-asserted employment tax liabilities which are being contested by taxpayers in both administrative and judicial proceedings.

The Treasury Department agrees with this statement.

Vote of the committee

In compliance with clause 2(1)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill. The bill, H.R. 14159, was ordered favorably reported by a rollcall vote of 33 in favor and 2 opposed.

IV. Other Matters to be Discussed Under House Rules

In compliance with clauses 2(1)(3) and 2(1)(4) of rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 14159.

Oversight findings

With respect to subdivision (A) of clause 2(1)(3), the committee advises that it was as a result of the committee's oversight activities with respect to the treatment of individuals as employees or independent contractors for purposes of employment taxes that the committee concluded that it is appropriate to enact the provisions contained in the bill.

The provisions of this bill originally were developed and recommended by the Ways and Means Committee's Task Force on Independent Contractors/Employees. The task force and staff held several public meetings with representatives of the Treasury Department, the Internal Revenue Service, the Tax Division of the Justice Department, and the Social Security Administration in attendance. Meetings also were held with representatives of the accounting and bar associations, as well as representatives of various industry groups. The committee intends to review this subject further next year in order to develop a comprehensive solution to the uncertainty under present law pertaining to the tax treatment of independent contractors and employees for employment tax purposes.

New budget authority and tax expenditures

With respect to subdivision (B) of clause 2(1)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority. The bill involves no new or increased tax expenditures.

Consultation with Congressional Budget Office on budget estimates

With respect to subdivision (C) of clause 2(1)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's explanation of its budget estimate (as indicated in part III of this report) and agrees with the statement.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(1)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary impact

In compliance with clause 2(1)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

Senate Version of § 530

Calendar No. 1187 95th CONGRESS—2d SESSION

H.R. 13511

[Report No. 95-1263]

IN THE SENATE OF THE UNITED STATES

August 14 (legislative day, May 17), 1978

Read twice and referred to the Committee on Finance

October 1 (legislative day, September 28), 1978

Reported, under authority of the order of the Senate of September 28, 1978, by Mr. Long, with an amendment

[Strike out all after the enacting clause and insert the part printed in italic]

AN ACT

To amend the Internal Revenue Code of 1954 to reduce income taxes, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

TITLE V—OTHER TAX PROVISIONS

SEC. 501. Determination of Who Is an Employee for Purpose of Employment Taxes.

(a) GENERAL RULE.—In determining whether an individual is an employee for purposes of chapters 21, 23, and 24 of the Internal Revenue Code of 1954, the Internal Revenue Service shall not apply any changed position or any newly stated position which is inconsistent with a general audit position in

effect prior to January 1, 1976, or which is inconsistent with a regulation or ruling in effect on December 31, 1975.

(b) GOOD FAITH REQUIREMENTS.—Notwithstanding subsection (a), an individual shall not be treated as an employee of any person for purposes of chapters 21, 23, and 24 of the Internal Revenue Code of 1954 if such person, in good faith, consistently treated such individual or the class of individuals of which such individual is a member as independent contractors for such purposes. Such person shall be deemed to have acted in good faith only if—

(1) all Federal tax returns (including information returns) required to be filed by such person were filed on a basis consistent with such person's treatment of such individual or such class of individuals as independent contractors; and

(2) such individual or such class of individuals were treated by such person as independent contractors in reasonable reliance on any of the following:

(A) past Internal Revenue Service audit practice with respect to such person;

(B) published rulings or judicial precedent;

(C) recognized practice in the industry of which such person is a member; or

(D) long-standing treatment by such person of such individual or such class of individuals of which such individual is a member as independent contractors for employment tax purposes.

In no event shall such person be deemed to have acted in good faith if the treatment of such individual or such class of individuals as independent contractors would, on the basis of the pertinent facts and circumstances, constitute negligence, intentional disregard of rules and regulations, or fraud within the meaning of section 6653 of the Internal Revenue Code of 1954.

(c) EFFECTIVE DATE.—The provisions of this Act shall apply in determining the employment status of individuals for—

(1) all calendar quarters for which, on the date of enactment of this Act, assessment of an underpayment of tax, or refund of an overpayment of tax, under chapters 21, 23, and 24 of the Internal Revenue Code of 1954 is not barred by the operation of any law or rule of law, and

(2) for the calendar quarter in which this Act is enacted and for all future calendar quarters until the end of the calendar year in which the Congress enacts a law terminating the future applicability of this Act.

SEC. 502. Reporting Requirements with Respect to Charged Tips.

(a) RECORDS.—Section 6001 (relating to notice or regulations requiring records, statements, and special returns) is amended by adding at the end thereof the following: "The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts and copies of statements furnished by employees under section 6053(a).".

(b) RETURNS.—Section 6041 (relating to information at source) is amended by redesignating subsection (d) as subsection (c) and by adding at the end thereof the following new subsection:

"(d) SECTION DOES NOT APPLY TO CERTAIN TIPS.—This section shall not apply to tips with respect to which section 6053(a) (relating to reporting of tips) applies.".

**Comptroller General's Report,
November 21, 1977 (Excerpted)**

COMPTROLLER GENERAL'S REPORT TO THE JOINT COMMITTEE ON TAXATION CONGRESS OF THE UNITED STATES

TAX TREATMENT OF EMPLOYEES AND SELF-EMPLOYED PERSONS BY THE INTERNAL REVENUE SERVICE: PROBLEMS AND SOLUTIONS

DIGEST

Key elements of an efficient tax system are that the tax laws be clear, unambiguous and not subject to arbitrary interpretation, both for the taxpayer and the Government. Who may be classified an employee as opposed to a self-employed person presently is not clear and is subject to conflicting interpretations by the Internal Revenue Service. Clarification would benefit both the Government and taxpayers.

COMMON LAW DEFINITION OF EMPLOYEES DIFFICULT TO INTERPRET

With the exception of certain job classifications the current definition of who is an employee and who is self-employed is based on the common law. Under the common law the factor determining whether a worker is self-employed or an employee is the degree of control, or right of control, the employer has over the worker. (See pp. 5 to 10.)

Accurate determinations are important because they involve millions of tax dollars. If workers are employees, their employers must withhold and pay to the Government income and social security taxes from their wages. The employers must also contribute to the social security fund at the same rate as their employees and, in most instances, pay an unemployment insurance tax.

IRS frequently determines that persons have been misclassified as self-employed and should, instead, be considered em-

ployees. Such determinations by IRS are generally retroactive. When this happens:

—Employers can be retroactively assessed employment taxes for 3 current tax years. (The statute of limitations generally relieves them of responsibility for taxes due before that period.)

—Double taxation can occur when the employer and employee pay income and social security taxes on the same income.

—Self-employment (Keogh) retirement plans established by individual taxpayers can be declared invalid with all prior untaxed contributions and income earned thereon becoming taxable in the current year. (See pp. 12 to 16.)

Many businesses have asked the Congress to develop statutory language that would clarify the definition of employee and self-employed or provide legislative relief from retroactive tax assessments.

GAO reviewed some of the alternatives proposed by business and found all of them to be inadequate in some respect. However, there is a solution that would reduce the extent of uncertainty.

Many IRS decisions that workers are employees and not self-employed involve clear-cut cases as defined by the tax laws and/or in accordance with the common law criteria. However, IRS has interpreted the common law definition of an employee in such a way that persons operating separate businesses are often considered the employees of another business because one can exercise a certain amount of control over the other.

This interpretation has been one of the primary sources of controversy in this area and has an impact on many persons such as barbers, beauticians, real estate sales agents, insurance agents, and service station operators who claim to be self-employed independent contractors. (See pp. 18 to 34.)

RECOMMENDATIONS

Where separate business entities exist, some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without necessarily creating an employer/employee relationship under the common law. On the other hand, there should be a clear-cut test to assure that *only* legitimately independent businesses are excluded from common law criteria and that the tax obligations of the employer-employee relationship are not being avoided by subterfuge.

Accordingly, the Congress should amend section 3121 of the Internal Revenue Code to exclude separate business entities from the common law definition of employee in those instances where they:

—Have a separate set of books and records which reflect items of income and expenses of the trade or business;

—Have the risk of suffering a loss and opportunity of making a profit;

—Have a principal place of business other than at a place of business furnished by the persons for whom he or she performs or furnishes services; and

—Hold themselves out in their own name as self-employed and/or make their services generally available to the public.

There may be some situations where a worker is able to meet some, but not all of the above criteria and still have a valid basis for being considered self-employed. In these circumstances some type of common law criteria should be applied, but not unless there is evidence that the worker's situation tends toward being one of a self-employed individual.

The Congress should amend section 3121 of the Internal Revenue Code to require separate business entities to meet three of the four criteria noted in the previous recommendation before using common law criteria to determine employ-

ment status. If the independent contractor cannot meet at least three of the criteria, GAO recommends that he be considered to be an employee.

To avoid unnecessary burdens on those businesses that elect to or must obtain the services of independent contractors, GAO also recommends that the Congress amend the Internal Revenue Code to provide that, absent fraud, IRS cannot make retroactive employee determinations in those cases where businesses (1) annually obtained a signed certificate from the persons they classify as self-employed stating that they meet all separate business entity criteria; and (2) annually provided IRS the name and the employer identification or social security number of all such certificate signers.

The certificate should be

—signed by the contractor under penalty of perjury, and

—in a form approved by the Secretary of the Treasury.

(See pp. 45 and 46.)

TREASURY'S REACTION

The Department of the Treasury and IRS comments on GAO's report (see app. V) state that the report has made a contribution in emphasizing the need for certainty in the area. However, they do not agree that the GAO report provides an adequate basis for legislation. The Department objects to GAO's proposed solution but neither it nor IRS offers any alternative to solve the problem. It is unfortunate that this is the case since IRS has been studying this issue for at least three years.

IRS' primary concern is that any change in the law which increases the number of self-employed taxpayers will result in lost tax revenues. IRS views self-employed taxpayers as having a low compliance rate in reporting income earned.

Using a limited sample, GAO estimated that employees formerly classified as self-employed persons had reported be-

tween 89 and 92 percent of the income earned when they considered themselves to be self-employed.

IRS was concerned that GAO's compliance rate was not accurate and undertook a study of its own. This study showed an overall compliance rate of 74 percent. But even after its own study, IRS concluded that neither study was conclusive regarding the "true level of compliance."

GAO concedes that IRS' compliance problems could increase but it questions whether tax compliance rates should be the primary concern in deciding how to clarify the laws. Congress has already determined that there should be both employees and self-employed persons. The GAO recommendation only adds clarity to that distinction.

IRS has an array of administrative tools available to insure compliance. Only if those tools are inadequate should Congress consider eliminating or controlling the number of self-employed persons as a means of increasing compliance. Nowhere in Treasury's comments is there any indication that IRS is studying, or committed to identifying ways to more effectively administer the law as it applies to self-employed persons. (See pp. 35 to 42 for a detailed analysis of Treasury's comments.)

The Departments of Labor and Justice are also concerned that the GAO criteria will permit taxpayers to be considered self-employed when they have the form but not the substance of self-employment. (See pp. 42 to 44.)

Retroactive Assessments Should Be Applied More Accurately

Adoption of GAO's recommended criteria will help employers and IRS make more accurate and consistent employment status determinations. But there will still be cases in which businesses do not withhold the proper income and social security taxes from their employees.

This includes situations where (1) "self-employed" persons are reclassified as "employees," (2) nonwage payments to

employees are reclassified as wages, and (3) employees (employees' status not disputed) are not included on a business' employment tax return. The IRS assessment practices in such instances, including those relating to computing interest and applying appropriate penalties, need to be improved to eliminate certain tax inequities.

If an employer can produce evidence indicating that its employees claim to have paid their proper tax, IRS will eliminate the assessment against the employer for nonwithheld income taxes. However, former employees cannot always be located nor do they always cooperate with their former employer. In these cases the assessed tax is not eliminated.

In many instances, IRS has information that would allow it to ascertain whether employees paid taxes on the income received from the employer. It does not, however, use this information to eliminate the assessment. By not using this information IRS can collect income taxes twice on the same income—once from the employer and once from the employee.

Also, GAO found that social security taxes are frequently collected twice on the same income. Unless the statute of limitations has expired, IRS is precluded by the Internal Revenue Code from reducing the social security tax assessed under the Federal Insurance Contribution Act by any social security taxes the employees have paid under the Self-Employment Contributions Act. This is because the self-employment tax was technically paid in error and the employees could seek refunds of the tax payments. Generally, however, they do not seek to recover such payments. Consequently, social security taxes are being collected twice on the same income—once from the employer and once from employees. (See pp. 47 to 56.)

RECOMMENDATIONS

GAO recommends that the Congress:

—Amend section 6521 of the Internal Revenue Code to authorize IRS to reduce the employees' portion of

social security taxes assessed against employers by an appropriate portion of the self-employment social security taxes paid by reclassified employees for the open statute years. (See p. 57.)

GAO also recommends that the Commissioner of IRS, through appropriate policy and procedural revisions:

—Require his auditors, in computing the initial tax assessment, to use information in IRS files on tax payments made by those employees for whom social security numbers are available but from whom tax payment certificates were not obtained by employers.

—Automatically refund to the reclassified employees the balance of self-employment taxes paid over the employee's social security taxes due.

GAO also recommends that the Commissioner improve the way IRS computes interest and applies the appropriate penalties. (See pp. 57 and 58.)

Treasury and IRS agreed with GAO's recommendation that the Congress amend the Code to reduce the employees' portion of social security taxes assessed against employers by the amount of self-employment taxes previously paid. They also agreed with the recommendations and plan to take corrective action regarding the way they compute interest and apply penalties.

Treasury and IRS opposed the recommendations that IRS (1) use information in its file to determine an initial correct tax assessment against employers and (2) automatically refund to reclassified employees the amount by which self-employment taxes paid exceed the employee's share of social security taxes due. This opposition was apparently the result of their misunderstanding our recommendation. GAO amended its recommendation to clarify its intent. (See pp. 58 and 59).

CHAPTER 1

INTRODUCTION

> "The tax which each individual is bound to pay out to be certain, not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. * * * The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality * * * is not near so great an evil as a very small degree of uncertainty."

This statement appeared in Adam Smith's "Wealth of Nations," as one of his canons of taxation. While the statement appeared over 200 years ago, it is still applicable today, especially as it relates to taxes which must be paid when an employer-employee relationship exists.

The laws defining who is an employee for tax purposes are uncertain, unclear, and subject to conflicting interpretations. Accurate interpretation is important because the withholding of Federal employment taxes (income and social security taxes) on wages applies only to employees. Other Federal taxes applicable to employee wages include the employers' share of social security taxes under the Federal Insurance Contribution Act (FICA), and unemployment taxes under the Federal Unemployment Tax Act (FUTA).

The Internal Revenue Service (IRS) is responsible for assessing and collecting these taxes.

EMPLOYEE VERSUS SELF-EMPLOYED DETERMINATIONS

IRS generally relies on the employers to initially determine whether their workers are employees or self-employed. IRS audits are the check on the validity of these determinations.

With certain specific exceptions, the Internal Revenue Code (26 U.S.C. 3121(d)) defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." Under the common law the determining factor is the degree of control, or right to control, the employer has over the worker. Little importance is attached to the form of the relationship. Thus, a job contract, separate bookkeeping, and separate business locations appear to have little effect in determining whether the person is an employee or is self-employed.

In the past the Congress, industry representatives, and other affected parties have expressed concern over the use of the common law criteria to define "employee." Because of this concern and the difficulty in applying the common law to certain hard to define occupations, the Congress added several statutory exceptions to the common law definition of employee. This was accomplished in 1950 through amendments to the Internal Revenue Code when agent and commission drivers, full-time life insurance salesmen, homeworkers, and traveling and city salesmen were defined as employees. By adding the statutory categories, the Congress clarified the status of certain occupations in the "twilight zone" between employee and self-employed classifications. For this same reason, the Congress recently, under the Tax Reform Act of 1976, excluded certain fishermen from being considered employees for withholding and social security tax purposes.

Other industries with hard to define occupations now seek congressional relief from the IRS position that the relationship with their workers is within the common law definition of employer-employee. They claim that the common law definitions as administered by IRS are unclear and not uniformly applied. Many also complain that inequities occur because common law does not recognize the independent contractor status of many salespersons or distributors who sell their products. This includes certain "independent" insurance salesmen and gasoline station operators. Others, however, see no

problem with the common law definition. Their complaint is the way IRS interprets it.

IRS, on the other hand, is greatly concerned that the degree of voluntary compliance with our tax laws will decline as more persons are classified as self-employed. Thus, the Service tends to classify as many persons as possible as employees, thereby subjecting their earnings to withholding.

REVIEW OBJECTIVES AND SCOPE

Because of these various concerns, the Joint Committee on Taxation asked us to review IRS administration of taxes on self-employment income, including the classification of persons as either self-employed or employees.

This report deals with the (1) difficulties employers and IRS face in determining who is an employee and who is self-employed and (2) retroactive assessments against employers who IRS believes have misclassified employees.

We examined IRS policies, procedures, and practices for reclassifying self-employed persons as employees; and for retroactively assessing the employer for taxes he should have withheld from wages paid to these employees.

As part of the review we also randomly sampled cases from the universe of all cases IRS closed during 1975 in which there was an abatement of at least some of the employment taxes assessed. We limited our study to those cases involving abatement because they were the ones most likely to have employee/self-employed issues involved. We assumed that the vast majority of employee/self-employed cases would have had at least one abatement for current "employees." Further, the sample was also designed to provide our base data for evaluating the adequacy of IRS' abatement procedures.

The universe was 1559 cases. Using random sampling techniques, we sampled 259 cases. This technique allowed us to make statistical projections to the universe at the 95 percent confidence level.

We classified the 259 cases into the following categories.

Category	*Sample size*
1. Self-employed reclassified as employee	92
2. Non-covered wages reclassified as covered for withholding or social security tax	13
3. Employer did not withhold income or social security taxes from employees (employee status not disputed)	35
4. Employment tax assessment abated for administrative reasons (e.g. to correct an error)	73
5. Unable to determine—insufficient file data or files could not be located	46
Total	259

To test the criteria we developed for determining self-employed persons we analyzed the 92 sample cases in which IRS had reclassified 1,070 workers as employees. These workers were in various types of industries and occupations where the problem of classification as employee or self-employed exists and were primarily used to develop the findings presented in Chapter 2.

To assess the adequacy of IRS abatement procedures, we used the sampled cases in the first three categories noted above. Chapter 3 discusses the findings as a result of our analysis of the 140 cases.

CHAPTER 2

IRS AND BUSINESS TAXPAYERS DISAGREE OVER WHO SHOULD BE CONSIDERED EMPLOYEES: WHY; RESULTS; SOLUTIONS

IRS and business taxpayers frequently disagree over whether various business relationships with individuals are that of employer-employee under the common law definitions. IRS interpretation of a common law employee is more strict—more likely to result in a finding of employee status—than that of

business and, in many instances, the courts. This is particularly troublesome because IRS relies on business taxpayers to make the initial employment status determinations which may later be subjected to IRS audit.

The term "common law" is not defined in the statutes. It is a body of law and legal theory based on customs and usages that originated and developed in England. The common law definition of employee is based on a master-servant relationship where the master directs and controls the work performed by the servant.

Under the common law, a worker is an employee if the person for whom he works has the right to direct and control the way he works, both as to the final result and as to the details of when, where, and how the work is to be done. It is the IRS view that the employer need not actually exercise control. It is sufficient that he has the right to do so.

IRS has adopted 20 rules (see app. I) to determine whether workers are employees. In brief, these rules are directed at the following questions.

1. Is the person providing services required to comply with instructions about when, where, and how the work is to be done?
2. Is the person provided training to enable him to perform a job in a particular method or manner?
3. Are the services provided integrated into the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the person performing services under contract?
6. Is the relationship between the individual and the person he performs services for a continuing relationship?
7. Who sets the hours of work?

8. Is the worker required to devote his full time to the person he performs services for?
9. Is the work performed at the place of the business of the potential employer?
10. Who directs the order or sequence in which the work must be done?
11. Are regular oral or written reports required?
12. What is the method of payment—hour, week, commission, or by the job?
13. Are business and/or traveling expenses reimbursed?
14. Who furnishes tools and materials used in providing services?
15. Does the person providing services have a significant investment in facilities used to perform services?
16. Can the person providing services realize both a profit or a loss?
17. Can the person providing service work for a number of firms at the same time?
18. Does the person make his services available to the general public?
19. Is the person providing services subject to dismissal for reasons other than nonperformance of contract specifications?
20. Can the person providing services terminate his relationship without incurring a liability for failure to complete a job?

If an employer-employee relationship exists under the common law rules, the parties involved cannot by contract or other means define the relationship otherwise for tax purposes. Thus, it is of no consequence that the employee is designated

as a partner, coadventurer, agent, independent contractor, or the like.

COMMON LAW RULES DIFFICULT TO APPLY

Why do IRS, employers, accountants, lawyers, and other advisors have difficulty determining whether a person is an employee or is self-employed? One reason is that the application of the common law rules to specific employee/self-employed situations is open to broad and inconsistent interpretation. For example, not all of these rules are always present in every employment situation. Some of the rules do not apply to certain occupations. Further, the rules vary as to applicability and importance in different situations. Evaluating the weight to be given various rules is often a subjective matter, even though IRS and employers make a strong and comprehensive effort to develop all relevant facts. As a result, many employers cannot, with any degree of certainty, determine who will be considered an employee until after IRS has audited the situation.

Another reason IRS, employers, and their advisors have difficulty in making employment status determinations is that contracts, past industry practice, and the incurring of business expenses do not make an individual self-employed where the common law elements of control exist. For example, many people operate businesses that are separate entities from those for whom they perform services. These people, in the course of running their business, may

—hire, direct, and pay assistants;

—provide their own office, equipment, materials and other work facilities;

—have continuing and recurring liabilities or obligations;

—perform certain jobs for prices agreed upon in advance and pay expenses incurred in connection with the work; and

—realize a profit or loss from the business based on his or her management of the business.

Even where these conditions are present, IRS may still determine the operator of the business to be an employee if certain aspects of the job are controlled by the business which contracted for the job to be done.

Example:

—John Jones operates a service station.

—He rents the station from the same company he purchases gasoline from.

—The rent is included in the price he pays for the gasoline.

—John hires and pays employees to work in the station.

—John's income statement shows the following:

Gross sales receipts		$100,000
Less: rent and cost of goods sold		45,000
Gross profit		$ 55,000
Less: Other business expenses		
Wages paid to employees	$30,000	
Insurance	900	
Utilities	1,500	
Service truck expense	1,500	
Supplies, towels, uniforms	500	
Employment taxes (FICA & FUTA)	2,500	
Miscellaneous expense	100	
		37,000
Net profit		$18,000

—John pays his income and self-employment social security taxes on the $18,000 net income.

—IRS determines that the supplier has the right to direct and control John Jones in the way he works.

Under these circumstances IRS would rule that an employer-employee relationship exists. The supplier would be assessed

for the income and employee social security taxes that should have been withheld. The assessment would be based on $55,000 gross income, not the $18,000 net income.[1] The employer would also be assessed for unemployment taxes and its matching share of social security taxes. Penalties and interest can also be added to the assessment. Such assessments can be applied retroactively for up to 3 years.

COMMON LAW RULES NOT UNIFORMLY APPLIED

The former director of the IRS Legislative Analysis Division told us that it is not uncommon for two knowledgeable individuals to disagree on an employee status determination given the same set of circumstances. He said that the employment tax law should have more certainty for the benefit of both the employer and employee and that guidelines should be provided to the taxpaying public which permit it to make its own determinations with certainty.

IRS has not provided such guidelines. The results are misclassifications of employees by employers and inconsistent and conflicting interpretations of the common law rules by IRS personnel in different geographic areas.

The problems associated with this latter point are illustrated by one large national manufacturing company which had contracted with independent franchise sales outlets to sell and service its products. Persons operating the sales outlets were treated by the manufacturer as self-employed persons. It was brought to the attention of IRS that the franchise sales outlets had received different employment status determinations by IRS agents in cases involving substantially similar facts. As a result, IRS stopped its agents from making employment determinations in this case until the national office could furnish them guidance.

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1 FICA tax and income tax withholding is assessed on "wages" which is defined by law (26 U.S.C. 3121(a) and 26 U.S.C. 3401(a) as *all* remuneration for employment. SECA tax is assessed on "self-employment income" which is defined by law (26 U.S.C. 1402(b) as *net* earnings from self-employment.

The difficulty of conflicting interpretations of the common law rules is further highlighted by IRS audit contradictions. IRS individual tax audits sometimes treated individuals as self-employed while agents auditing the business the individuals worked for classified them as employees.

As discussed on page 3, we sampled 92 employers who had self-employed workers reclassified as employees. We were able to indentify 59 of their "employees" who had their income tax returns audited by IRS—13 were audited as a result of their "employer's" audit and 46 were audited independent of their "employer's" audit. Of these 46 individual audits 11 (24 percent) had income on which IRS assessed self-employment social security tax. This income was subsequently reclassified as employee wages subject to employee social security tax under FICA when IRS audited the employers.

For example, one worker reported on his 1973 return "other" income of $4,652 which was received for driving a truck for a family owned company. IRS representatives, during a 1975 audit of his return classified the earnings as self-employment income and assessed him $372 in self-employment social security tax. At the same time, other IRS representatives were conducting an employment tax audit of the family-owned company, and the worker was subsequently classified as an employee. As a result the IRS officials assessed FICA social security taxes on the same income that SECA taxes had been paid on.

What Type of Worker Is Being Reclassified?

Some of the industries which are hit the hardest by IRS reclassification of worker status are those that rely on a direct sales organization to sell their products. This includes many oil product suppliers who market gasoline through contractual arrangements with individuals who operate service stations owned or leased by the supplier, and insurance companies who rely on "independent insurance agents" to sell their policies. IRS frequently determines other direct sales organizations to

be employers of those persons who sell their products door-to-door or through home party plans.

IRS reclassifications are not limited to these large, well organized industries. Other workers IRS reclassified as employees included carpenters, painters, entertainers, truck drivers, store managers, nurses, security guards, and mechanics.

Many of the persons reclassified by IRS are small businesses—often one person—separate from, but under a certain degree of control of, other businesses whose product they sell or for whom they perform services. Reclassifications are made even though such persons can incur nonreimbursable costs; can suffer a loss, as well as make a profit; maintain separate books and records; and have a principal place of business at locations other than on the premises of the supplier or the business to which the services are provided.

Other persons being reclassified perform their services on the premises and use the equipment and facilities of the contracting business. The service provided is supervised and directed in the same manner as an employee. The principal difference is that a service contract exists.

Often the difference between an employee and a self-employed independent contractor is difficult to distinguish. For example, what is the difference between a building guard supplied under contract by a large protective agency, an off-duty policeman who independently contracts his services as a building guard, and a building guard on the company payroll? The duties and hours worked by each are the same. The off-duty policeman has elements of being a one-man protective service agency as well as elements of being an employee. In his case, what is the difference between a fixed salary and fixed contract fee? Questions such as these cause problems in defining employees. IRS interprets to the Government's advantage and the business interprets to its advantage.

EMPLOYEE VERSUS SELF-EMPLOYED DETERMINATIONS BENEFIT EMPLOYERS AND IRS DIFFERENTLY

IRS and employers often approach employee/self-employed determinations differently. IRS examines the employment relationship from the viewpoint of "can the worker be considered an employee?" Employers, on the other hand, view the relationship from the perspective of whether the worker can be considered self-employed. This difference in perspective may be due to the objectives each has in assessing the same situation. Benefits will accrue to either IRS or the employer depending on a worker's classification. At stake are millions of dollars in employment taxes.

Benefits to IRS

Classifying individuals as employees makes collecting taxes easier for IRS since the tax is collected from only one employer rather than from several self-employed individuals. Other reasons why IRS prefers the workers to be classified as employees include;

— withholding of employment taxes by the employer provides for an even flow of tax dollars into the treasury,

Report of Staff of the Joint Committee on Taxation, February 28, 1979

[JOINT COMMITTEE PRINT]

ISSUES IN THE CLASSIFICATION OF INDIVIDUALS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

A REPORT

Prepared by the Staff of the

JOINT COMMITTEE ON TAXATION

Submitted to the

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

and the

COMMITTEE ON FINANCE

UNITED STATES SENATE

February 28, 1979

U.S. Government Printing Office
Washington : 1979

B. Origin of Controversies: Increased IRS Enforcement

In the late 1960's, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification,

the taxpayer became liable for employment taxes—withholding, social security, unemployment—which neither had been withheld nor paid to the Treasury.

The retroactive reclassification of independent contractors as employees by the Internal Revenue Service could give rise to four general types of problems: (1) taxpayers whose workers were reclassified as employees could be assessed employment taxes retroactively for years not subject to the statute of limitations; (2) double taxation could occur if the taxpayers paid withholding assessments for the same liabilities for which workers had paid income tax; (3) overpayments of social security taxes could occur if taxpayers paid FICA taxes with respect to workers who had paid SECA taxes; and (4) retirement plans could be disqualified.

When the IRS reclassified a worker, previously treated as an independent contractor, as an employee, the person who was found to be the employer generally was held responsible for all employment tax liabilities (income tax withholding and both the employer's and the employee's share of social security taxes) with respect to the individual who was reclassified as an employee. The IRS generally would adjust Federal income tax withholding assessments if the employer was able to furnish certificates signed by his or her workers showing that the workers had paid their proper amount of income tax (Code sec. 3402(d)). Thus, the burden was on the employer to prove that the individuals who had been reclassified as employees had paid their income taxes. In situations where there were only a few workers, and the workers still lived in the employer's vicinity, and had maintained adequate records and were cooperative, this proof was not difficult. However, in situations where there were many workers, a high turnover rate, or the workers maintained inadequate records or were uncooperative, obtaining this proof could be very difficult and expensive.

Unlike the income tax withholding liability, the reclassified employee's share of FICA tax generally was not abated by the IRS by the amount of SECA tax already paid on the same

income. Present law (Code sec. 6521(a)) authorizes a FICA-SECA offset only if the employee is prevented by law from filing for a refund of the SECA tax paid in error. This rule may result in the double collection of the employee's portion of social security tax: (1) once from the employer as the FICA tax he or she initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error. The employer's portion of the FICA tax assessment does not represent a double payment because that portion of the tax was not paid previously if workers were not treated as employees; it is paid for the first time after reclassification of such workers.

The reclassification of a worker as an employee also may have adverse effects on self-employed (H.R. 10) retirement plans. If the individual previously had received a determination from the IRS that he or she was an independent contractor and then was reclassified as an employee, the retirement plan would be frozen and any future contributions to the plan would not be exempt from tax. If the individual previously had not received such a determination, the plan would be disqualified and all amounts in the plan (previous contributions plus income) would be taxable. Furthermore, if an employer previously had established a qualified retirement plan for some workers whose status as employess was recognized, and the IRS subsequently reclassified as employees additional workers whom the employer had been treating as independent contractors, the previously qualified retirement plan for the employees could be disqualified for failure to meet the minimum "coverage" requirements (Code sec. 410(b)).

Many taxpayers complained that proposed reclassifications involved a change of position by the Internal Revenue Service in interpreting how the common law rules applied to their workers or industry. Some taxpayers had prior private letter rulings or technical advice memoranda from the Service in which the Service held that the workers were independent contractors. Others pointed to prior audits in which their treatment of workers as independent contractors was not

challenged. Before the 1970's, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published revenue rulings.

During the last few years, the IRS published pairs or groups of revenue rulings which contained one or more restatements of earlier rulings determining workers to be independent contractors and other rulings determining that workers in the same general industry, but under somewhat different circumstances, were employees. Taxpayers have pointed to these so-called "bracketed rulings" as evidence of changes in IRS positions. (The Internal Revenue Service generally has viewed these rulings as distinguishing prior rulings or as interpreting new or changed relationships.)

Upon an assessment of an employment tax, the only judicial remedy which ordinarily is available to a taxpayer is the payment of the tax followed by a refund suit in a district court.[1] However, employment taxes are divisible taxes, *i.e.*, they are predicated upon the employment of an individual for a quarter. Therefore, a taxpayer may challenge an assessment, due to a reclassification of workers incident to an audit or otherwise, by paying the tax for one worker for one quarter, and then suing for a refund of that tax.[2] Generally, such a refund suit also would include a claim for an abatement of the unpaid, but previously assessed, taxes. In practice, the Service ordinarily then will counterclaim for the balance of the assessment.

This procedure allows a resolution of the employment status issues without necessitating that the full amount of the assessment be paid prior to litigation. However, many taxpayers have found such litigation an unsatisfactory method of resolving employment tax disputes. This results in part from the costs and time involved in both the judicial and administrative

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1 Because the Tax Court lacks jurisdiction over employment taxes, a suit cannot be commenced without paying the tax.

2 See, *e.g.*, *Marvel v. U.S.*, 548 F.2d 295 (10th Cir. 1977).

phases of the resolution of the issue. In addition, some taxpayers point to the fact that there is no assurance that the Service will refrain from levying on the taxpayer's property during the pendency of the litigation,[3] and to the fact that the litigation itself creates a contingent liability which ordinarily must be noted for financial statement purposes.

C. Legislative Action

1. Original legislation and interpretation

Although Congress specifically has classified certain occupational categories of individuals as either employees (sec. 3121(d)(3)) or independent contractors, it generally has maintained the use of the common law control test for determining employment status.

The original employment tax provisions, which were contained in the Social Security Act of 1935, defined the term "employee" to include a corporate officer. The Treasury Regulations promulgated in 1936 under this Act defined the term "employee" in the same manner as it is defined in the present regulations pertaining to the common law test.

In 1939, the Social Security Board proposed to expand the definition of the term "employee" to include "more of the persons who furnish primarily personal services," such as various salespersons.[1] The Board explained that these individuals were "for all practical purposes employees," notwithstanding the fact that they might be classified otherwise under common law. In H.R. 6635, the House of Representatives

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3 In partial payment litigation, the Service is not precluded by section 6213 from levying against a taxpayer's property. However, in most situations there is little likelihood of a unilateral seizure by the Service in the absence of circumstances which might jeopardize the availability of the taxpayer's funds subsequent to the litigation. See *Marvel v. U.S.*, 548 F.2d 259, 39 AFTR2d 679, 680 n.1 (10th Cir. 1977); Internal Revenue Manual, Supp. 5547.

1 Hearings before the House Committee on Ways & Means Relative to the Social Security Act Amendments of 1939, 76th Cong., 1st Sess. 8, 11, 61-62, 64 (1939).

adopted this definition both for Social Security benefit purposes and for FICA tax purposes.[2] However, it rejected it for FUTA purposes. Thus, the House would have based the classification of an individual "as an employee" on the "economic reality" and the appearance of the relationship between an individual and a business.

The House definition contained in H.R. 6635, however, was rejected by the Senate,[3] which believed it to be "inexpedient to change the existing law which limits coverage to employees." The Senate version of the bill was adopted in conference,[4] and thus, the original definition remains in present law.

The original income tax withholding provisions, which were enacted as part of the Current Tax Payment Act of 1943, adopted a definition of "employee" which was virtually identical to the present definition in section 3401(c) of the Code. This definition was based on the Victory Tax withholding provisions, which had been added to the Internal Revenue Code of 1939 by section 172 of the Revenue Act of 1942. The Victory Tax and the Current Tax Payment Act embodied the Congressional decision that the principal test for the determination of employment status should be the common law master-servant relationship. Under this test, a common law employer-employee relationship was to exist if the person for whom the services were to be performed had the right to exercise control over the result desired to be accomplished, as well as the manner in which it was effectuated. Thus, both the Victory Tax and the Current Tax Payment Act excluded from the definition of an employee, individuals who would not be classified as such under the common law concept of master and servant. This decision, in turn, was embodied in the Treasury

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2 H.R. 6635, 76th Cong., 1st Sess. secs. 606, 801 (1939); H.R. Rep. No. 728, 76th Cong., 1st Sess. 61-62, 76-77 (1939).

3 H.R. 6635, 76th Cong., 1st Sess. secs. 606, 801 (1939). S. Rep. No. 734, 76th Cong., 1st Sess. 75, 88 (1939).

4 H.R. Rep. No. 1461, 76th Cong., 1st Sess. 14, 18 (1939).

Regulations issued under these Acts. Those regulations are essentially identical to the present employment tax regulations.

In 1947, the Supreme Court decided several cases in which it applied an "economic reality" test in the determination of the employment tax status of certain individuals.[5] Following these decisions, the Treasury Department issued proposed regulations which would have replaced the common law control test for the determination of whether an individual is an "employee" for FICA and FUTA purposes with an "economic reality" test.[6] Under the proposed regulations, the existence and degree of the right of control over the performance of services by an individual would have been one of six factors to be used for the determination of an individual's employment status. The crux of the test in the proposed regulations would have been an individual's economic dependence upon the business in connection with which services were rendered.

In response to the 1947 Supreme Court decisions, and the proposed Treasury Regulations, the Congress passed the "Gearhart" Resolution of 1948.[7] This resolution expressed the Congressional intent that the term "employee" should continue to be defined for FICA and FUTA purposes with regard to the status quo, and not pursuant to an "economic reality" test. Thus, under the "Gearhart" Resolution, Congress expressed its intent to exclude from the definition of "employee" any individual who occupied the status of an independent contractor under the common law regulations and to exclude any individual who was not an "employee" under those regulations from the term "employee for FICA and FUTA purposes." The Gearhart Resolution was passed over President Truman's veto.

The House Report accompanying the Gearhart Resolution rejected the "economic reality" test of the Supreme Court's decisions, but the Senate Report reconciled the rationale of

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5 See *U.S. v. Silk*, 331 U.S. 704 (1947); *Harrison v. Greyvan Lines Inc.*, 331 U.S. 704 (1947); *Bartels v. Birmingham*, 332 U.S. 126 (1947).

6 12 F.R. 7966-7969 (1947).

7 P.L.No. 80-642, H.J.Res. 296, 80th Cong., 2d Sess. (1948).

those decisions with the common law regulations. The Senate report explained that the "economic reality" factors applied by the Court were relevant to the common law test because they were interwoven with the "end-point determination of whether . . . common law control" existed.

2. Tax Reform Act of 1976

The House and Senate conferees on the Tax Reform Act of 1976 included in the Statement of Managers a request that until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent contractors,[8] the Internal Revenue Service "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years." The Joint Committee on Taxation had previously asked the General Accounting Office (GAO) to examine the Internal Revenue Service's administration of employment taxes, including the classification of individuals as either self-employed individuals or as employees.

3. Report by the General Accounting Office

The GAO report[9] indicated that the principal problem with regard to the classification of individuals for employment tax purposes is the uncertainty in the interpretation and application of the governing common law rules. In its report, the GAO noted that this uncertainty has created difficulty for individuals, employers, tax practitioners, and tax administrators. After surveying a broad range of industries and workers, the GAO concluded that uncertainty and controversies most frequently arise in cases in which an individual operates a business which is separate from, or subordinate to, another

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8 H.R. Rep. No. 94-1515, 94th Cong., 2d sess. 489 (1976).

9 Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," GGD-77-88, November 21, 1977.

business which the Internal Revenue Service may consider to be the individual's employer.

The GAO did not believe such a relationship should always be considered one of employer-employee but should in some cases be treated as a self-employment situation involving an independent contractor. The GAO report includes both legislative and administrative recommendations for establishing specific criteria for classification purposes and for instituting procedures for alleviating possible double taxation in reclassification cases.

Classification proposal

The GAO specifically recommended that the Congress amend section 3121 of the Code to exclude the owner of a separate business entity from the common law definition of employee in those instances where he or she meets all the following requirements:

> (1) has a separate set of books and records which reflect items of income and expenses of the trade or business;
>
> (2) has the risk of suffering a loss and the opportunity of making a profit;
>
> (3) has a principal place of business other than at a place of business furnished by the persons for whom he or she performs or furnishes services; and
>
> (4) holds himself or herself out in his or her own name as self-employed and/or makes his or her services generally available to the public.

The GAO noted that in some situations a worker may meet some, but not all, of the four criteria and still have a valid basis for being classified as self-employed. In such circumstances, the GAO believes that some type of common law criteria should be applied, but only if there is evidence that the worker is a self-employed individual. To deal with such cases, the GAO recommended that the Congress amend section 3121

of the Code to require that separate business entities meet three of the four criteria before using common law criteria to determine employment status. The GAO recommended that workers be considered employees if they cannot meet at least three of the proposed criteria.

Limitation on reclassifications

The GAO further recommended that the Code be amended to prohibit the IRS from retroactively reclassifying workers as employees, except in cases involving fraud, where a business: (1) obtained annually from the persons whom the business classified as self-employed signed certificates stating that these persons meet all four of the separate business entity criteria, described above; and (2) annually provided the IRS the name and the employer identification or social security number of all such certificate signers. The GAO further proposed that the certificate should be signed by the contractor under penalty of perjury, in a form approved by the Secretary of the Treasury.

In order to alleviate the problem of double collection of social security taxes on the same income, the GAO recommended that the Congress amend section 6521 of the Code to authorize the IRS to reduce the employees' portion of FICA taxes assessed against employers by an appropriate portion of the self-employment taxes (SECA) paid by reclassified workers for the open statute years.

4. Revenue Act of 1978: interim relief

The Revenue Act of 1978[10] provides interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed

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10 P.L. 95-600, H.R. 13511, sec. 530. This matter was also the subject of a similar, separately reported bill in the 95th Congress. H.R. 14159, which was reported by the House Ways and Means Committee (H.R. Rep. 95-1748, Oct. 10, 1978). The provisions adopted in the Revenue Act of 1978 were based on a Senate amendment, which followed S. 3007, a Senate bill, as well as H.R. 14159.

reclassifications of workers, until 1980 to give the Congress adequate time to resolve the many complex issues involved in this area.

General

The Revenue Act of 1978 provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees by—

(1) terminating certain employment tax liabilities for periods ending before January 1, 1979,

(2) allowing taxpayers, who had a reasonable basis for not treating workers as employees in the past, to continue such treatment for periods ending before January 1, 1980, while the Congress works on a comprehensive solution, without incurring employment tax liabilities, and

(3) prohibiting the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.

Termination of certain pre-1979 employment tax liability

The Act provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassifications of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees. For purposes of determining such taxpayers' employment tax liabilities, the Act provides that workers shall be deemed not to be the taxpayers' employees, unless the taxpayers had no reasonable basis for not treating the workers as employees.

Liabilities terminated under the Act are those for Federal income tax withholding, Social Security (FICA), and unemployment (FUTA) taxes for any period ending before January 1, 1979, during which the taxpayers did not treat the workers as employees.

It is not necessary that a taxpayer have treated workers other than as employees for all pre-1979 periods in order to qualify for relief. A taxpayer who treated workers as employees for some pre-1979 periods, may obtain relief for other pre-1979 periods when they were treated other than as employees, provided there was a reasonable basis for such treatment. (However, an anti-abuse rule, discussed later, denies relief for periods during 1979, if the taxpayers' treatment of workers other than as employees is inconsistent with the treatment of such workers for any period beginning after December 31, 1977.)

Generally, the Act terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. The Congress intended that this reasonable basis requirement be construed liberally in favor of taxpayers. In addition, the Act establishes several alternative statutory standards which constitute "safe havens," and thus, when met, qualify a taxpayer for the termination of employment tax liability.

The first statutory reasonable basis standard is met if a taxpayer's treatment of an individual as not being an employee for a period was due to reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a private ruling, for example, a "letter ruling," or a "determination letter," issued to the taxpayer. Under this test, the precedent or published ruling upon which a taxpayer reasonably relied doe not have to relate, necessarily, to the particular industry or business in which the taxpayer is engaged.

Under the second statutory "safe haven" standard, a taxpayer is treated as satisfying the reasonable basis test for the treatment of an individual as other than an employee for employment tax purposes, by showing reasonable reliance on a past Internal Revenue Service audit of the taxpayer. Such an audit need not have been for employment tax purposes. However, a prior audit would qualify as a "safe haven" basis for a taxpayer's reliance only if the audit entailed no assessment

attributable to the taxpayer's treatment (for employment tax purposes) of individuals holding positions substantially similar to the position held by the individual whose treatment is at issue. However, a taxpayer does not meet this second test if in the conduct of a prior audit an assessment attributable to the taxpayer's treatment of an individual was offset by other claims asserted by the taxpayer.

The third statutory method for a taxpayer to establish a reasonable basis for the treatment of an individual as other than an employee is to show that such treatment coincided with a long-standing, recognized practice of a significant segment of the industry in which the individual whose status is at issue was engaged. This test does not require that a practice be uniform throughout an entire industry.

The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as other than an employee are not the exclusive ways of meeting the Act's reasonable basis requirement. A taxpayer who can demonstrate a reasonable basis for the treatment of an individual in some other manner also is entitled to termination of employment tax liabilities.

Termination of employment tax liabilities under the Act is made available to taxpayers who are under audit by the Internal Revenue Service or who are involved in administrative or judicial proceedings with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or for a credit of any overpayment of an employment tax resulting from the proposal's termination of liability, provided the claim is not barred on the Act's date of enactment by any law or rule of law.

Taxpayers who have entered into final closing agreements under section 7121 or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the Act, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed to or compromised a liability for an amount which is to be paid in installments, but who still has one or more installments to pay,

is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Internal Revenue Service or who unsuccessfully litigated such cases are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, an unsuccessful litigant in an employment status case, who fulfills the Act's requirements, can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

Eligibility for relief for pre-1979 periods is to be determined independently of a taxpayer's eligibility for relief for any periods in 1979. With respect to pre-1979 periods, there is no requirement that the taxpayer have filed all Federal tax returns (including information returns), required to be filed with respect to an individual whose status is at issue, on a basis consistent with the taxpayer's treatment of such individual as not being an employee.

Employment tax liability for 1979

Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers. Therefore, the Act allows taxpayers to continue to treat workers as other than employees through 1979, unless the taxpayers have no reasonable basis for not treating the workers as employees. However, in order to qualify for relief for 1979, the Act also provides that taxpayers must file all Federal tax returns (including information returns) required to be filed for periods after December 31, 1978, with respect to workers whose status is at issue, on a basis consistent with the taxpayers' treatment of the workers other than as employees. Thus, the Act prospectively relieves taxpayers of liabilities which they might incur during 1979. The Congress intends to work on formulating comprehensive legislation on the employment tax status controversy during this period.

Except for the filing requirement, taxpayers' eligibility for the prospective relief from 1979 liabilities is determined under the same tests and the same liberal interpretations of the tests which determine eligibility for pre-1979 relief.

It is expected that legislation developed during 1979 to clarify the employment tax status of individuals would become effective on the earlier of January 1, 1980, or the date of enactment, and would replace present law for all periods thereafter.

Anti-abuse provision

To prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions, the Act denies relief in such circumstances. The Act prohibits the termination of any potential employment tax liability with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor) has treated an individual holding a substantially similar position as an employee for any period beginning after December 31, 1977. The application of this provision to taxpayers and their predecessors is intended to prevent avoidance of this rule, for example, by reincorporations.

Refunds or credits of overpayments

The Act allows taxpayers at least a one-year period for filing claims for refunds or credits attributable to the relief provided in the Act. If a taxpayer's claim for refund or credit is not barred on the Act's date of enactment by any law or rule of law, the taxpayer has at least until November 6, 1979, that is, the date one year after the Act's date of enactment, for filing a claim. If the taxpayer is entitled to a longer period under the general statute of limitations for filing such claims, the longer period applies.

Generally, taxpayers should file refund or credit claims asserting grounds for relief under the Act with the Internal

Revenue Service. If the taxpayer already has an open claim filed with the Service, or is involved in litigation over such a claim with the Department of Justice, the original claim will qualify as a claim for relief under this provision, provided the taxpayer notifies either the Service or the Department of Justice, whichever is appropriate, within the proper time period, of the taxpayer's basis for relying on the Act for relief.

Penalties and interest

If a taxpayer is relieved of liability for any tax under the provision contained in the Revenue Act, any liability for interest or penalties attributable to such tax liability is forgiven automatically. This relief applies to all such interest and penalties for both pre-1979 and 1979 liabilities, whether charged directly against the taxpayer or personally against the taxpayer's officers.

Workers' status, liabilities and rights

The Act does not change in any way the status, liabilities and rights of an individual whose employment status is at issue.

Prohibition against IRS Revenue Rulings and Regulations

The Act also prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling classifying individuals for purposes of employment taxes under interpretations of the common law. This prohibition became effective November 6, 1978 the date of enactment of the Act, and remains in effect until January 1, 1980, or, if earlier, the effective date of any law subsequently enacted to clarify the employment status of individuals for purposes of employment taxes.

The prohibition applies to Revenue Rulings having precedential status but does not apply to the issuance of private letter rulings requested by taxpayers. The prohibition does not extend to regulations or Revenue Rulings based on statutory provisions dealing with the employment tax status of particular

workers, such as certain fishermen, which do not involve the application of common law standards; nor does the prohibition apply to the determination of matters such as effective dates, which do not entail issues of common law employment status for purposes of employment taxes.

This provision was effective upon enactment (November 6, 1978).

Report of the Staff of the Joint Committee on Taxation, March 12, 1979 (Excerpted)

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION

OF THE

REVENUE ACT OF 1978

(H.R. 13511, 95TH CONGRESS; PUBLIC LAW 95-600)

Prepared by the Staff of the

JOINT COMMITTEE ON TAXATION

March 12, 1979

D. OTHER TAX PROVISIONS

1. Employment Tax Status of Independent Contractors and Employees (sec. 530 of the Act)

Prior law

With certain limited statutory exceptions, the classification of particular workers or classes of workers as employees or independent contractors (self-employed persons) for purposes of Federal employment taxes, is made under common law rules. A determination of whether an employer-employee relationship exists is important because a certain amount of wages paid to employees generally is subject to Social Security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and unemployment taxes are imposed on the employer under the Federal Unemployment Tax Act (FUTA). On the other hand, payments to independent contractors are subject to the tax on self-employment income

(SECA). In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

Generally, the basis for determining whether a particular worker is an employee or independent contractor is the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee is deemed to exist. On the other hand, the absence of a right to control generally indicates that the person performing the services is an independent contractor. In interpreting the Treasury regulations, twenty factors are used in determining whether workers are employees or independent contractors.

Reasons for change

In the late 1960s, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification, the taxpayer became liable for employment taxes—withholding, social security, and unemployment—which neither had been withheld nor paid to the Treasury.

In some cases, the assessments were for liabilities already satisfied directly by workers, who paid their own income and self-employment taxes. The IRS has agreed to allow taxpayers certain income tax and FICA-SECA offsets, if they provide the Service with their workers' names and social security numbers. However, many taxpayers lack such information about their workers and cannot benefit from this procedure.

Many taxpayers have complained that proposed reclassifications involve a change of position by the Internal Revenue

Service in interpreting how the common law rules apply to their workers or industry. Some taxpayers have prior private letter rulings or technical advice memoranda from the Service in which the Service said that the workers were independent contractors. Other taxpayers have pointed to prior audits in which their treatment of workers as independent contractors was not challenged. Before the 1970s, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published Revenue Rulings.

During the 1976 Tax Reform Act conference, House and Senate conferees included in the Statement of Managers a request that the IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent contractors.

The Congress believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.

Explanation of provisions

General

The Act provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees by—

(1) terminating certain employment tax liabilities for periods ending before January 1, 1979,

(2) allowing taxpayers, who had a reasonable basis for not treating workers as employees in the past, to continue such treatment for periods ending before January 1, 1980,

while the Congress works on a comprehensive solution, without incurring employment tax liabilities, and

(3) prohibiting the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.[1]

Termination of certain pre-1979 employment tax liability

The Act provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the Service's proposed reclassifications of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees. For purposes of determining such taxpayers' employment tax liabilities, the Act provides that workers shall be deemed not to be the taxpayers' employees, unless the taxpayers had no reasonable basis for not treating the workers as employees.

Liabilities terminated under the Act are those for Federal income tax withholding, Social Security (FICA), and unemployment (FUTA) taxes for any period ending before January 1, 1979, during which the taxpayers did not treat the workers as employees. It is not necessary that a taxpayer have treated workers other than as employees for all pre-1979 periods in order to qualify for relief. A taxpayer who treated workers as employees for some pre-1979 periods, may obtain relief for other pre-1979 periods when they were treated other than as employees, provided there was a reasonable basis for such treatment. (However, an antiabuse rule, discussed later, denies relief for 1979 periods, if the taxpayers' treatment of workers other than as employees is inconsistent with the treatment of such workers for any period beginning after December 31, 1977.)

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1 The text of this provision, which originated as a Senate floor amendment, is similar to a separately reported bill, H.R. 14159, which was reported by the House Ways and Means Committee (H. Rept. 95-1748, October 10, 1978).

Generally, the Act terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. The Congress intends that this reasonable basis requirement be construed liberally in favor of taxpayers. In addition, the Act establishes several alternative statutory standards which constitute "safe havens," and which, when met, qualify a taxpayer for the termination of employment tax liability.

The first statutory reasonable basis standard is met if a taxpayer's treatment of an individual as not being an employee for a period was due to reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a ruling, for example, a "letter ruling," or a "determination letter," issued to the taxpayer. Under this test, the judicial precedent or published ruling upon which a taxpayer reasonably relied does not have to relate, necessarily, to the particular industry or business in which the taxpayer is engaged.

Under the second statutory "safe haven" standard, a taxpayer is treated as satisfying the reasonable basis test for the treatment of an individual as other than an employee for employment tax purposes, by showing reasonable reliance on a past Internal Revenue Service audit of the taxpayer. Such an audit need not have been for employment tax purposes. However, a prior audit would qualify as a "safe haven" basis for a taxpayer's reliance only if the audit entailed no assessment attributable to the taxpayer's treatment (for employment tax purposes) of individuals holding positions substantially similar to the position held by the individual whose treatment is at issue. A taxpayer does not meet this second test if in the conduct of a prior audit an assessment attributable to the taxpayer's treatment of an individual was offset by other claims asserted by the taxpayer.

The third statutory method for a taxpayer to establish a reasonable basis for the treatment of an individual as other than an employee is to show that such treatment coincided with a long-standing, recognized practice of a significant segment of

the industry in which the individual whose status is at issue was engaged. This test does not require that a practice be uniform throughout an entire industry.

The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as other than an employee are not the exclusive ways of meeting the Act's reasonable basis requirement. A taxpayer who can demonstrate a reasonable basis for the treatment of an individual as other than an employee in some other manner is also entitled to termination of employment tax liabilities.

Termination of employment tax liabilities under the Act is made available to taxpayers who are under audit by the Internal Revenue Service or who are involved in administrative or judicial proceedings with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or for a credit of any overpayment of an employment tax resulting from the Act's termination of liability, provided the claim is not barred on the Act's date of enactment by any law or rule of law.

Taxpayers who have entered into final closing agreements under section 7121 or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the Act, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed or compromised a liability for an amount which is to be paid in installments, but who still has one or more installment to pay, is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Internal Revenue Service or who unsuccessfully litigated such cases are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, an unsuccessful litigant in an employment status case who fulfills the Act's requirements, can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

Eligibility for relief for pre-1979 periods is to be determined independently of a taxpayer's eligibility for relief for any periods in 1979. With respect to pre-1979 periods, there is no requirement that the taxpayer file all Federal tax returns (including information returns), required to be filed with respect to an individual whose status is at issue on a basis, consistent with the taxpayer's treatment of such individual as not being an employee.

Employment tax liability for 1979

Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers. Therefore, the Act allows taxpayers to continue to treat workers as other than employees throuhgh 1979, unless the taxpayers have no reasonable basis for not treating the workers as employees. However, in order to qualify for relief for 1979, the Act also provides that taxpayers must file all Federal tax returns (including information returns) required to be filed for periods after December 31, 1978, with respect to workers whose status is at issue, on a basis consistent with the taxpayers' treatment of the workers other than as employees. Thus, the Act prospectively relieves taxpayers of liabilities which they might incur during 1979. The Congress believes that work on formulating comprehensive legislation on the employment tax status controversy should be undertaken during this period.

Except for the filing requirement, taxpayers' eligibility for the prospective relief from potential 1979 liabilities is to be determined under the same tests and the same liberal interpretations of the tests which determine eligibility for pre-1979 relief.

It is expected that legislation developed during 1979 to clarify the employment tax status of individuals would become effective January 1, 1980, or the date of enactment of clarifying legislation, whichever is earlier, and would replace present law for all periods thereafter.

Anti-abuse provision

To prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions, the Act denies relief in such circumstances. The Act prohibits the termination of any potential employment tax liability with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor taxpayer) has treated an individual holding a substantially similar position as an employee for any period beginning after December 31, 1977. The application of this provision to taxpayers and their predecessors is intended to prevent avoidance of this rule, for example, by reincorporations.

Refunds or credits of overpayments

The Act allows taxpayers at least a one-year period for filing claims for refunds or credits attributable to the relief provided in the Act. If a taxpayer's claim for refund or credit is not barred on the Act's date of enactment by any law or rule of law, the taxpayer will have at least until the date one year after the Act's date of enactment for filing a claim. If the taxpayer is entitled to a longer period under the general statute of limitations for filing such claims, the longer period applies.

Generally, taxpayers should file refund or credit claims asserting grounds for relief under the Act with the Internal Revenue Service. If the taxpayer already has an open claim filed with the Service, or is involved in litigation over such a claim with the Department of Justice, the original claim qualifies as a claim for relief under this provision, provided the taxpayer notifies either the Service or the Department of Justice, whichever is appropriate, within the proper time period, of the taxpayer's basis for relying on the Act for relief.

Penalties and interest

If a taxpayer is relieved of liability for any tax under this provision, any liability for interest or penalties attributable to such tax liability is forgiven automatically. This relief applies to all such interest and penalties for both pre-1979 and 1979 liabilities, whether charged directly against the taxpayer or personally against the taxpayer's officers.

Status, liabilities and rights of individual employees and independent contractors

The Act does not change in any way the status, liabilities and rights of an individual whose employment status is at issue.

Prohibition against IRS Revenue Rulings and Regulations

The Act prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling classifying individuals for purposes of employment taxes under interpretations of the common law. This prohibition becomes effective on the date of enactment of the Act and will remain in effect until January 1, 1980, or, if earlier, the effective date of any law subsequently enacted to clarify the employment status of individuals for purposes of employment taxes.

The prohibition applies to Revenue Rulings having precedential status but does not apply to the issuance of private letter rulings requested by taxpayers. Moreover, the prohibition does not extend to regulations or Revenue Rulings based on statutory provisions dealing with the employment tax status of particular workers, such as certain fishermen, which do not involve the application of common law standards; nor does the prohibition apply to the determination of matters such as effective dates, which do not entail issues of common law employment status for purposes of employment taxes.

Effective date

This provision was effective upon enactment (November 6, 1978).

Revenue effect

The revenue effect of this provision cannot be estimated because the provisions affects IRS-asserted employment tax liabilities which were contested by taxpayers in both administrative and judicial proceedings.

I.R.S. General Counsel Memorandum 38029
(July 24, 1979)

Internal Control No.: CC:I-113-79
Br2:DFConley

Uniform Issue List Nos.:
3121.02-00, 3306.03-00, 3401.04-00

AARON FEIBEL

Acting Assistant Commissioner (Technical)

Attention: Director, Individual Tax Division

By memorandum dated April 24, 1979, (copy attached) Director, Tax Litigation Division, asked Interpretative Division to consider whether to recommend that Individual Tax Division (T:I:WEA:P) suspend publication of two related proposed revenue rulings: *** Control Number 76-6-31184 (June 14, 1976); *** Control Number 77-11-49305 (June 28, 1977).

The issues addressed by these rulings generally concern employment tax consequences of certain services performed by individuals in connection with distribution and sale of newspapers. Each ruling asserts that the individuals involved are employees of the respective newspaper companies. Given this employer-employee relationship, *** questions whether business activity of these individuals in servicing newspaper vending machines, compensation for which is on a commission basis, is excepted from the definition of "employment" for FICA and FUTA purposes under I.R.C. §§§ 3121(b)(14) and 3306(c)(15), and from the definition of "wages" for withholding tax purposes under section 3401(a)(10). *** poses the same questions in the context of business activity in delivering newspapers to home subscribers. Both rulings conclude that such services are not excepted from the FICA and FUTA definition of employment, and related commissions are not excepted from the withholding definition of wages.

Tax Litigation Division takes the view that publication of these proposed revenue rulings should be suspended on account of the congressional directive embodied in the Revenue Act of 1978, Pub. L. No. 95-600, § 530(b), 92 Stat. 2763 (1978). Section 530(b) prohibits the Service from publishing any revenue ruling before January 1, 1980, with respect to the employment status of any individual for purposes of the employment taxes. Section 530(c)(2) defines the term "employment status" to mean the "status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee)."

Although both proposed revenue rulings state as a fact that individuals performing the specified services in connection with distribution and sales of newspapers are employees of the respective newspaper companies, the rulings could be misinterpreted to read that an "employment status" determination has been made with respect to such individuals. This determination comes within the statutory proscription of section 530(b). Accordingly, we recommend publication of the subject proposed rulings be suspended pending a legislative solution in this troublesome area.

Note our recommendation in this matter is based only on our interpretation of the scope of the section 530(b) prohibition. A larger question, posed by the April 24, 1979, memorandum from Tax Litigation Division and expanded upon in attached correspondence between Tax Litigation Division and Department of Justice, concerns applicability of the employment tax liability termination rules of section 530(a) to controversies centered on the statutory exceptions from "employment" or "wages." Section 3121(b), 3306(c), and 3401(a). It appears from the attached correspondence that the litigation staff of the Office of Chief Counsel and Department of Justice, Tax Division, have made the decision that taxpayer relief under section 530(a) is available in controversies such as that presented by the subject cases.

In our view there is scant technical support for the position adopted by the litigation staff—particularly as that position

presumably will be applied even in those cases in which the taxpayer concedes the common law "employee" issue and simply argues that an exception from "employment" provides relief from employment tax liability. On the other hand, it is doubtful that the Service would enjoy any success in litigating employment tax issues to which section 530 has even a remote bearing; and for this reason we believe the litigation staff has adopted a reasonable and prudent approach in recommending settlement of these cases.

LESTER STEIN

Acting Chief Counsel

By: TERRY J. HARTZEL
Reviewer
Interpretative Division

Enclosures:
April 24, 1979, memorandum from Tax Litigation Division, with enclosures.

Date: Apr 24, 1979

To: Director, Interpretative Division

From: John H. Menzel, Director
Tax Litigation Division

Subject: ***

Proposed Revenue Ruling, Control No. 76 6 31384

This Division has concluded that publication of the proposed revenue ruling in the above-captioned case and the companion *** case would violate section 530 of the Revenue Act of 1978 Pub. L. No. 95-600, 95th Cong. 2nd Sess. (Nov. 6, 1978). Subsection (b) prohibits publication of regulations or revenue rulings with respect to the employment status of any

individual for purposes of employment taxes after enactment of the act and prior to January 1, 1980.

Indications are that Technical, Individual Tax Division, has taken the position that section 530 does not apply to exceptions from employment and therefore, under that view, publication of the above-mentioned revenue rulings is not precluded by the act. We disagree with that interpretation of the act, concluding that these rulings involve an employment status controversy to which the statutory prohibition applies.

Facts:

The issue in the case is whether services performed by certain individuals constitute employment for FICA and FUTA tax purposes or if they fall within the statutory exceptions from employment as provided by section 3121(b)(14)(B) and 3306(c)(15)(B). *** a subsidiary of ***, corporate plaintiff in this case, employs certain individuals under its rack sales program to sell its newspapers through vending machines. The salesmen rent the machines from *** and sell the papers at a fixed price. Unsold papers are returned to the company and credited to the salesmen. Individual plaintiff, *** is one such route manager. A few of these individuals spend up to 10 percent of their time in work for the newspaper unrelated to vending machine sales.

In a letter ruling dated June 14, 1976, plaintiff was advised that the exclusions from employment tax liability provided by I.R.C. § 3121(b)(14)(B) of the Federal Insurance Contribution Act (FICA) section 3306(c)(15)(B) of the Federal Unemployment Tax Act (FUTA) and section 3401(a)(10)(B) of the Collection of Income Tax at Source on Wages (withholding) did not apply to the services performed by these individuals. The ruling concluded that the exceptions required that individuals meeting its terms perform services "in and at the time of" the sale. Since the route managers were not present when a patron purchased the paper from the vending machine, the Commissioner ruled the exceptions were inapplicable. The ruling further concluded that the services performed by these individuals were not of the type contemplated by the exceptions.

Subsequent to issuance of the letter ruling, a proposed revenue ruling was drafted and was concurred in by Chief Counsel on September 6, 1977. The ruling, along with a similar one involving *** Control Number 77 11 49305, is currently being coordinated with the Social Security Administration. Initially, Social Security indicated its disagreement with the substance of the rulings. Apparently, upon resolution of the disagreement between Technical and Social Security, the rulings are to be published.

Discussion:

Section 530 of the Revenue Act of 1978 provides relief from employment tax liability when an employer has not treated an individual as an employee for any period before January 1, 1980 and had a reasonable basis for not treating the individual as an employee. There is some disagreement as to its applicability to exceptions from employment.

The issue in litigation here is whether the services provided are excluded from "employment". Section 530, by its terms, applies to "Controversies Involving whether Individuals are Employees." Arguably it is not clear that this is the type of controversy to which relief was intended to apply. If it does not apply to exceptions from employment, then the publication of the revenue rulings is not affected by section 530(b) prohibition.

In support of that position, the regulations governing the exclusions from employment under subsections 3121(b) and 3306(c) clearly contemplates situations in which an individual is an employee but the services performed by that employee are not "employment" for FICA and FUTA purposes. See Treas. Reg. § 31.3121(b)-4. Prior to passage of the Revenue Act of 1978, the plaintiffs never raised the issue of the status of these employees. In fact, a review of the legal file indicates plaintiff's basic position throughout has been that these individuals were common law employees but the services fell within the statutory exceptions.[1]

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1 *** request for ruling states these individuals, were "now considered by *** to be its employees".

On the other hand, although plaintiffs did not approach the issue as one of the individuals' status as common law employees, the nature of the exceptions raises that issue implicitly and makes section 530 applicable to the merits of the controversy for two reasons. First, *** can argue that even if the statutory exclusions do not apply here, these individuals are not common law employees within the usual tests. Indeed, if these individuals are neither statutory employees nor excluded under section 3121(c) or 3306(d), implicit in the Service's position is the contention that they are common law employees. To assert employment tax liabilities against *** the Commissioner must then rely on the common law tests.

Second, it is not entirely clear that Congress did not intend section 530 to apply to exclusions from employment. Committee reports, legislative history, the Service and DOJ all agree that the relief provisions are to be applied liberally. With that viewpoint established, it is difficult to conclude that the fine distinction drawn as to applicability to exclusions from employment (and at one time statutory) employees) is a supportable one.

Even if one were to accept as valid a general rule that section 530 relief does not apply to controversies involving exclusions from employment, that distinction alone need not preclude its application to the particular exclusions involved in this case. Examination of the legislative history reveals the exceptions at issue here were meant to distinguish newspaper vendors as independent contractors if they met the statutory tests. Whether they fall within the common law definition of employee is immaterial. The committee report accompaning these exceptions reads in part:

> Regardless of whether news vendors are or are not technically employees under some decisions in recent cases . . . the common law tests while thoroughly valid, are inadequate . . . should be treated as independent calling . . . these vendors would not be treated as employees; that to consider them as employees of the publishing firms whose products they buy and sell produces a ridicu-

lous and absurd rule. S. Rep. No. 985, 80th Cong., 2nd Sess. reprinted in (1948) U.S. Code Cong. & Ad. News, 1473.

This is consistent with the position taken by the DOJ in the memorandum of law in support of the government's motion for summary judgment on the merits, before section 530 was enacted.

Apart from the fact that the distinction being drawn with regard to exclusions from employment is an unsupportable one, the Individual Tax Division's Wages, Excise and Administrative Provisions Branch has already recommended an administrative refund in a case involving *Knight-Ridder Newspaper, Inc.* There the issue was also whether services were excepted from FICA and FUTA liability under I.R.C. §§ 3121(b)(14) and 3306(c)(15). The WEA branch argues that the situation is distinguishable because the taxpayer never conceded the individuals were common law employees.

We disagree with the interpretation of the act as being inapplicable to exclusions from employment. As a result of our conclusion that section 530 does apply to these exceptions, we have recently recommended that the Department of Justice make full administrative settlement in the refund suit. By enactment of section 530(b) Congress intended to temporarily suspend rulings in all controversies involving employment status until new legislation could be enacted. We believe publication of the rulings violates the spirit if not the letter of the law. Because of the conflict between our position and that of the Individual Tax Division, we are referring to your Division for consideration the question of whether the rulings can be published. If you have any questions, please contact Ms. Clark of this office on extension 3583.

By: John C. Calhoun
Chief, Branch 1
Tax Litigation Division

Enclosure:
Proposed Revenue Rulings

CC: Mario E. Lombardo, Acting Director
Individual Tax Division

Additional Enclosure:
Settlement Letter to DJ
Letter and Memo from DJ

March 28, 1979

Honorable Stuart E. Seigel
Chief Counsel
Internal Revenue Service
Washington, D.C. 20224

Attention: John C. Calhoun
Chief, Branch 1

Re: ***
Your Ref: CC:TL-R-1023-77 Br1:DYClark

Dear Mr. Seigel:

Please find enclosed a copy of a memorandum which my associate, Mr. Hart, prepared for me. He recommended full administrative settlement in the *** suit, based on Section 530 of the Revenue Act of 1978.

I share the view set out in your letter of February 27, 1979, that plaintiff, *** is not granted relief under Section 530 with respect to the refund that it claims in this action. I have reached this conclusion because I believe the "test case" payment of employment taxes with respect to *** constitutes "treatment" for purposes of rendering Section 530 inapplicable to the claimed refund. To this extent I differ from the conclusion set out in Mr. Hart's memorandum. However, for the reasons there set forth it is my view that Section 530 is

applicable, and warrants Government concession, as to employment taxes on all distributors other than *** for the period in suit, and as to all employment taxes on all distributors for all periods not in suit.

Please contact me at your convenience so that we can attempt to reconcile our divergent positions.

Sincerely yours,

M. CARR FERGUSON
Assistant Attorney General
Tax Division

By: MILDRED L. SEIDMAN
Chief, Reveiw Section

Enclosure

Subject: ***

To: Mildred L. Seidman
Chief, Review Section

These suits are for refund of FICA and FUTA taxes. The plaintiff-employer in *** paid $308.34, the employer's share of FICA for the third quarter of 1976, and $21.00 in FUTA for the year 1976. The plaintiff in *** paid $308.34, the employee's share of FICA for the same quarter. The suits have been consolidated for trial.

The suits were brought together as a "test case" to determine the validity of an adverse ruling issued by the Service. *** had requested a ruling that the services rendered by its various newspaper distributors (of which ***s one) were excepted from the definition of employment pursuant to Sections 3121(b)(14)(B) (FICA), and 3306(c)(15)(B) (FUTA). Accordingly, there has been no Service audit with respect to the period

in suit, and no assessment by the Service of the amounts subject to the claim for refund.

The original issue in this case is somewhat more narrow than the scope of the ruling. It is whether the business activity of the distributors in servicing the plaintiff's vending machines, compensated in pertinent part on a commission basis, was, in spite of an acknowledged general employer-employee relationship on the part of the plaintiff and its distributors, excepted from the definition of employment for FICA and FUTA purposes pursuant to Sections 3121(b)(14)(B) and 3306(c)(15)(B), respectively.

While this issue is still alive, enactment of Section 530 of the Revenue Act of 1978 has introduced potentially superseding issues. In my judgment they are as follows:

> (1) whether Section 530 is applicable to "employment relationship" disputes within Section 3121(b), which provides certain exceptions from the definition of employment, where the plaintiff otherwise generally acknowledges that the group of individuals in question are its employees under the common law criteria of Section 3121(d)(2):
>
> (2) if Section 530 preliminarily applies to Section 3121(b) disputes then it must be determined whether the payment by *** of FUTA and the employer's share of FICA for the third quarter of 1976, with respect to the distributor *** is "treatment" of the latter's vending machine commissions as wages subject to employment taxes, due consideration being given to the absence of an audit or assessment to provoke payment.
>
> (3) if the "test case" payment is not "treatment" with respect to the vending machine commissions, whether the plaintiff's payment of WT-FICA, and FUTA taxes on the salary portion of the distributor's compensation, which certainly constitutes "treatment" within the meaning of Section 530, also necessarily means that the plaintiff should likewise be deemed to have "treated" the vending

machine commissions as wages subject to employment taxes.

Assuming that all the above issues are resolved in the taxpayer's favor, then, of course, the standard determination is whether one of the three statutory safe havens of Section 530 is met: or, in the alternative, whether the residual reasonable basis test is met.

CONCLUSION

Chief Counsel, in a supplemental defense letter of February 27, 1979, in essence contends that the plaintiff has failed the third issue above, and therefore recommends defense on the original issue.

The Trial Section (Messrs. Murray and Leedom) has requested our advice. While the issues in this case present close questions involving basically statutory interpretation, on balance I disagree with Chief Counsel's position.

For my part, the taxpayer does not clearly meet any of the statutory safe havens, but does meet the residual reasonable basis test. Accordingly, I would recommend withdrawal of the Government's cross-motion for summary judgment, and administrative settlement.

FACTS

The plaintiff *** is a newspaper in the *** area. To distribute its papers it employs certain individuals under its "rack sales" program who are known as distributors (one of which is ***. Most of the distributors nearly exclusively use vending machines to distribute the plaintiff's newspapers. *** rents these vending machines to the distributors for a fixed price (25 cents per week). Unsold newspapers are returned to *** and credited to the individual. The distributors bear the risk of theft or loss.

The rack sales employment agreement between *** and its distributors provides, in paragraph 6, that the relationship between *** and the distributor is one of employer-employee.

It appears that plaintiff as a general matter does not dispute this characterization of the relationship.

Of critical importance is the manner in which the distributors are compensated. Par. 2 of the rack sales agreement provides:

> Distributor will charge the retail price set by *** Distributor's compensation shall be based upon his retention of the excess of the retail price of newspapers sold to ultimate consumers through racks over the amount at which such newspapers are charged to him, *plus* a salary of *** per week for other services required by *** including the delivery of newspapers to independent retail outlets. (Emphasis supplied.)

It thus appears that the distributors received a commission on services related to vending machine sales, based on a differential between the retail price and the price *** charged the distributors; *in addition*, the distributors received a salary for "other services," not enumerated.

Discovery has ascertained that virtually all of the distributors spent virtually all (90 percent) of their time servicing the vending machines, although the weekly commissions therefrom approximated the weekly salary. Thus, "other services" were usually never rendered.

*** treated the salary component of the distributors' compensation as wages not excepted from the employment relationship by § 3121(b)(14)(B). It therefore paid WT-FICA, and FUTA taxes on this amount.

However, *** did *not* treat the vending machine commissions as wages, presumably on the basis that § 3121(b)(14)(B) applied to this amount. It therefore paid no employment taxes on this component. Only the propriety of this latter action is in issue.

LAW

Section 3121(b)(14)(B) provides:

> [The term 'employment' means . . . except that such term shall not include] service performed by an individual in, and at the time of, the sale of newspapers or magazines to ultimate consumers, under an arrangement under which newspapers or magazines are to be sold by him at a fixed price, his compensation being based on the retention of the excess of such price over the amount at which the newspapers or magazines are charged to him, whether or not he is guaranteed a minimum amount of compensation for such service, or is entitled to be credited with the unsold newspapers or magazines turned back . . .

Treas. Reg. Sec. 31.3121(b)(14)-1(b) states that services performed other than at the time of sale to the ultimate consumer are not within the exception. However, incidental services by the employee who makes the sale to the ultimate consumer, such as assembling newspapers or taking newspapers or magazines to the place of sale, are considered to be within the exception.

As previously noted, in 1976 *** requested a private ruling letter to the effect that both the salary and the vending machine commissions paid to the distributors were for services within the exception of § 3121(b)(14)(B). The Service issued an unfavorable ruling, holding that the exception was available only for services rendered by on-site newsstand operators. The Services' conclusion was based on a review of the provision's legislative history.[2]

The Service's adverse ruling did contain the following concession:

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2 Chief Counsel's initial defense letter of January 31, 1978, p. 6, n.1, indicates that HEW was of the opinion that § 3121(b)(14)(B) applied to both the vending machine commissions and the salary compensation. HEW relied upon what it regarded as the clear facial language of the statutory provision rather than the legislative history.

A copy of the HEW letter is attached.

However, the newspaper *** has supplied information that some of these individuals, in addition to selling papers through vending machines, sell papers through the operation of a conventional "newsstand", or by hand. To the extent that their sales of papers result from sales of papers through these methods, then the portion of their remuneration gained by selling papers by hand or through a newsstand operation is not "wages".

Issue No. 1.

Section 530 was enacted to provide relief to taxpayers principally involved in employment *status* controversies under the common law, since the preponderance of employment tax disputes related to the vagaries of applying common law criteria to a set of facts. Accordingly, the legislative history discusses the purpose of 530 in the context of this type of employment status controversy.

As you are, of course, aware, neither the language of § 530 nor the legislative history specifically includes or excludes applicaton of Section 530 to statutory employee disputes. In fact a negative inference of no coverage can arguably be drawn. However, it was our opinion that this apparent lacuna in § 530 should be flushed in by considering statutory employee disputes within its ambit, especially given § 530's broadly remedial purposes.

The Service now concedes that § 530 should be construed to cover statutory employee disputes. A sound rationale for this position is that had Congress considered the matter, encompassing statutory employee disputes within § 530 would surely be consistent with its intention of largely resolving in taxpayer's favor disputes in this contentious area of employment taxes.

Likewise, the statutory language of Section 530(a) nowhere limits its coverage to employee *status* disputes within

§ 3121(d).[3] While the legislative history indicates that the principal concern of the Congress was over such disputes, nowhere is there language limiting § 530 to the resolution of disputes under this provision. Moreover, there is no language specifically excluding "employment relationship" disputes under Section 3121(b) of the Code from § 530's beneficent coverage.

In accordance with the presumptive congressional intent, the broadly remedial purpose of Section 530, in my judgment, would be better effectuated by extending it to employment relationship disputes under Section 3121(b), rather than excluding such disputes from its ambit. While this construction is not ineluctably mandated either by the face of 530 or its legislative history, the analogous resolution of the statutory employee matter and the better part of wisdom suggest that the Government so construe it, especially given the emotionally-charged political atmosphere which suffuses the debate over employment taxes.[4]

---

3 Our consensus is that Sec. 530(c)(2), defining "employment status" relate only to Sec. 530(b), enjoining the Service from issuing rulings only under the common law criteria. This interpretation is in accord with the judgment of Michele Scott, Joint Committee staffer, that the drafters of the legislative history intended to cross reference subsection (c)(2) only to subsection (b) and *not* to subsection (a).

4 This construction is somewhat fortified by the interrelationship of Sec. 530(c)(1), which defines "employment tax" as any tax imposed by Subtitle of the Code, and the use of the term "employment tax" in § 530(a)(1)(A). The taxes in dispute here are clearly employment taxes. Note that § 530(a)(1)(A) nowhere uses the term "employment status" (defined by § 530(c)(2)). See n. *supra*.

The Joint Committee Staff Report of February 28, 1979, involving clarification of the seemingly intractable problems in employment *status* disputes, in § III E, stated that a possible solution is to expand the class of self-employed persons, citing § 3121(b). While the staff obviously did not focus on the relationship of § 530 and § 3121(b), nonetheless its analysis implicitly assumes that employee status disputes and § 3121(b) are conceptually consonant.

In sum, given the broadly remedial purpose of Section 530, the absence of a clear indication that Congress did not intend to apply the term to employment relationship disputes within Section 3121(b), the colorable argument that it so applies, and the adverse criticism which the Government has received for being allegedly doctrinaire and unreasonable in employment tax disputes. I would recommend that the Government concede that § 530 applies to disputes within Section 3121(b).

Issue No. 2.

Rev. Proc. 78-35, 1978-49 IRB 30, Sec. 3.02(A), and (B) jointly state that withholding FICA and the filing of Forms 940 and 941 constitute "treatment" of workers as employees, thus vitiating the applicability of Section 530. However, Sec. 3.02(C) states that the filing of such forms (and presumably also the withholding of such employment tax) pursuant to Service "compliance procedures" is not "treatment". Sec. 3.02(C) further states that compliance procedures encompass collection or examination activities (of which an audit would be an example).

In this case there was no audit; moreover, there was no Service-initiated compliance procedure of any kind for the period in suit. As discussed above, the plaintiff had requested a favorable ruling regarding Section 3121(b)(14)(B)'s applicability to its distributors. An unfavorable ruling issued on June 14, 1976. The plaintiff immediately paid the employer's share of FICA and the FUTA tax on the vending machine commissions of one distributor *** for the third quarter of 1976 as a "test case."

The legislative history of § 530 supplies no guidance as to whether this test case technique is "treatment". Rev. Proc. 78-35 implies that it may be considered treatment, since no compliance procedure prompted the payment of the FICA or FUTA (assuming that the issuance of an unfavorable ruling pursuant to a ruling request is not a compliance procedure, and I think it ought not to be so considered).

For my part, though, it would be overreaching for the Government to argue that a test case payment of this sort is "treatment" vitiating 530's applicability. The purpose of the payment and subsequent suits was merely to prevent the accumulation of large liabilities which the Service could assess against *** "retroactively". Section 530 was in large part enacted to obviate such retroactive assessments upon a taxpayer who believed he had a reasonable basis for regarding his employment tax liabilities as fully satisfied.

Accordingly, I would recommend that the Government concede that the test case payment by the plaintiff should not be considered "treatment", within the meaning of Section 530, of the vending machine commissions as wages for employment tax purposes.

Issue No. 3

The more difficult question is whether the services rendered by the distributors and compensated by the payment of a *salary*, which the taxpayer concededly treated as wages for employment tax purposes, necessarily means that the taxpayer also should be deemed to have "treated" the vending machine *commissions* as wages for employment tax purposes.

Chief Counsel, in its letter of February 27, 1979 (p. 3) states that it regards the plaintiff to have so treated the distributors as employees, apparently for this reason. Its position in part appears predicated on a literalist interpretation of Section 530 and Rev. Proc. 78-35. Since the plaintiff treated the distributors as employees with respect to the salary compensation, it should be deemed to have treated the persons as employees apparently for all purposes and with respect to all types of compensation.

If one accepts the proposition that § 530 applies to employment relationship disputes under Section 3121(b), then in this case the vocabulary of argument is not simply whether a plaintiff treated a worker for some purpose as an employee. The issue is whether treatment of one type of compensation as wages subject to employment taxes necessarily mandates that

other forms of compensation, concededly paid for the same services, should likewise be deemed to have been so treated.

The necessity for a finer discrimination becomes apparent by use of the following hypotheticals. Assume that each of the workers in dispute performed two entirely different kinds of services for the taxpayer. The workers rendered services as newspaper copyboys on a straight salary, and [illegible] as freelance artists solely on commission. Assume also that the taxpayer treated the worker *qua* copy boy as an employee for employment tax purposes, and that same worker *qua* artist as an independent contractor. The Service audits the taxpayer, and assesses employment taxes on the commission compensation paid the worker *qua* artist, which the taxpayer then pays.

It is difficult to sustain the argument that because the taxpayer paid employment taxes to the worker *qua* copyboy, he should also be deemed to have treated the worker *qua* artist as an employee, rendering § 530 inapplicable to the dispute.

Moving closer to the instant facts, but slightly modifying them, assume that the taxpayer paid workers a salary for services related to vending machine sales, and a differential commission for newsstand sales. The taxpayer treated the former as wages for employment tax purposes, but not the latter (Sec. 3121(b)(14)(B) being applicable). For my part, the correct conclusion is still that treatment of the salary as wages does not necessarily mean that the taxpayer also should be deemed to have treated (for purposes of Section 530) the newsstand commissions as wages subject to employment taxes.[5]

With respect to the facts of this case, the critical question is, of course, whether a resolution of this issue in favor of the taxpayer can be extended to situations involving payment of two forms of compensation for the same services (salary *plus*

5 The Service might likewise agree that compensation paid for different but related services can be distinguished for employment tax purposes. As previously noted, the Service in the generally adverse letter ruling acknowledged that commission compensation paid for newsstand sales were exempt from employment tax under § 3121(b)(14)(B), even if commissions on vending machines sales were not.

commission, both being allocable to the vending machine sales).[6]

As previously discussed, the Service in its February 27, 1979 letter implicitly contends that such an extension would do violence to the language of § 530. It reaches this conclusion in part because it focuses on the treatment of the employee, and not the treatment of the compensation in question. Also, on pp. 3, 4, of this letter it advances the following in support of its conclusion:

> It appears from the legislative history of the Revenue Act of 1978 that relief was granted where there was no treatment of individuals as employees because of congressional concern for taxpayers who had neither withheld nor paid the employment taxes and who were suddenly faced with liability on 'wages' already paid out. In those instances, under a subsequent determination of the Service, amounts which should have been withheld from wages were no longer available to the employer to satisfy the liability. Additionally, the employer would be required to provide its share of the taxes, when it had not made provisions for satisfying such liability.
>
> It would appear the requirement of 'treatment' was inserted in concern for the equities, providing interim relief to employers who were unprepared for the potentially large assessments. These considerations do not apply to employers involved in the employment tax status controversies but who have paid the tax: section 530 does not provide for relief under those circumstances. Such is the case here, where the Atlanta Newspapers had been withholding and paying the taxes.

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6 The Service (District Counsel, Iowa) in *Guarantee Mutual Life Co. v. United States*, Civ. No. 77-0-407 (D. Nebr.) conceded that treatment by plaintiff of its workers as statutory employees did not require a conclusion that for purposes of § 530 the plaintiff should be deemed to have "treated" them also as common law employees. This conclusion involved the same type of compensation (commissions) paid to workers for the same type of services: the sale of life insurance.

In my judgment our inquiry should focus not on the treatment of the recipient of the compensation, but on the type of compensation paid and its treatment. In this case the taxpayer never treated (except for test case purposes) the vending machine commissions as wages subject to employment taxes. How it treated the salary is thus largely irrelevant for purposes of this suit.[7]

Moreover, the Service's understanding of the equitable intent of § 530 to abate reasonably unforeseeable employment tax liabilities does not lead to rejection of its application in this case. On the contrary, this understanding commends application of § 530 as forcefully to this case as where the plaintiff has treated no amount as subject to employment taxes.

Here the taxpayer wanted to protect itself against large "retroactive" employment tax assessments with respect to the vending machine commissions. The fact that it timely withheld employment taxes on salary payments is a mere fortuity, and as irrelevant under this understanding as under the initial Service rationale. Indeed, the employment tax liabilities in this case might far exceed those incurred by a plaintiff in another case

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7 Both the Trial Attorney (Mr. Leedom) and I believe that taxpayer's counsel could have taken a more aggressive position in advising his client. That is, since § 3121(b)(14)(B) contemplates a differential commission possibly supported by a "guaranteed floor", and since a salary could arguably be a form of such a guarantee, the taxpayer could defensibly have regarded the salary as also exempt from employment taxes. Indeed, HEW held this position.

If so, this would give some plausibility to the Service's argument that treatment of the salary as wages means that the commissions should be vicariously deemed to have been so treated. Without extensively analyzing whether salary could or should be regarded as a form of a guarantee contemplated by § 3121(b)(14)(B). I believe the nearly universal recognition of the potentially different employment tax significance of a salary vis a vis commissions warrants in this case that the Government not gainsay the taxpayer's different treatment of the two forms of compensation. Moreover, neither the regulations nor any rulings provide guidance as to what constitutes a guarantee.

A contrary conclusion, urged by the Service, would in effect penalize the taxpayer for taking a conservative position.

who treated none of the amounts paid its workers as subject to employment taxes.

Accordingly, I would conclude that the plaintiff did not "treat" within the meaning of § 530 the vending machine commissions paid to its distributors as compensation subject to employment taxes solely by virtue of its concededly having so "treated" the salary as wages subject to such taxes. Nor are there any other facts to indicate that the plaintiff should be deemed to have "treated" for purposes of § 530 the vending machine commissions as subject to employment taxes.

Therefore, assuming that § 530 applies to Section 3121(b) disputes, and assuming that neither the "test case" payment of FICA and FUTA taxes with respect to one distributor's vending machine commissions nor the treatment of salary as wages necessitates the conclusion that the vending commissions should likewise be deemed so treated, the question then becomes whether the plaintiff satisfies one of the three safe havens of § 530, or the residual reasonable basis test.

In an affidavit dated December 27, 1978, submitted by the plaintiff with its supplemental motion for summary judgment, the taxpayer states that the Service has conducted an audit for each year of the last several years, with no change in the taxpayer's employment tax liability. I assume that the taxpayer is attempting to finesse entry into the safe haven of "past" Service audit contained in § 530(a)(2)(B). Almost certainly "past" means an audit for a taxable period prior to the period in suit (3rd qtr., 1976), although there is no legislative history on this point. Since it appears that audits were conducted only for periods subsequent to the period in suit, this safe haven appears inapplicable.[8]

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8 Note, though, that a no change audit for a subsequent period might arguably satisfy the residual reasonable basis test.

I have been informally advised by the Trial Attorney that the Service apparently has conducted an audit of the taxpayer *** for 1975, with no assessment for additional employment taxes. If so, then this safe haven is met, since the "rack sales" agreement was in effect in 1975.

The affidavit also states that the practice of the newspaper industry is to treat its distributors as independent contractors, presumably with respect to the vending machine commissions. If so, this would satisfy the test of § 530(a)(2)(C) regarding long-standing practice of a significant segment of the industry. Before acceptance of this statement as authoritative, in this case prudence dictates that the Government attempt to verify it, if we rely solely thereon to support an administrative settlement.

In any event, I am inclined to recommend administrative settlement based on the residual reasonable basis test. As previously noted, HEW regarded § 3121(b)(14)(B) as applicable to except the distributors' services, with respect to both salary *and* commission compensation, from the definition of employment for employment tax purposes. It is difficult to argue convincingly that the taxpayer had no reasonable basis for its more modest conclusion that § 3121(b)(14)(B) applied to the vending machine commissions, when HEW concluded that the exemption applies to both commission and salary compensation.

CONCLUSION

For the above reasons, I recommend administrative settlement of *** suit. I am authorized to state that Mr. Leedom concurs.

Of course, § 530 is applicable only to suits by putative employers, and *not* employees. H.R. Rep. No. 95-1748, 95th Cong. 2d Sess. p 7. Since *** is not an employer, but rather an employee, a decision regarding his suit must rest only on an analysis of § 3121(b)(14)(B). At this time I am reserving judgment on this issue. The Service is adamant that § 3121(b)(14)(B) is inapplicable, and I feel confident that if *** is granted a settlement pursuant to § 530, it will concede the *de minimis* amount in ***.[9]

* * *

9 If the Service were to prevail in its argument that § 530 was inapplicable it might well enjoy only a Pyrrhic victory. Discovery has shown that each distributor spent virtually all of his time rendering services to generate vending machine sales. If the Service loses on the merits, and the court holds that services, however compensated, related to vending machine sales are covered by § 3121(b)(14)(B), then not only will the taxpayer recover the *de minimus* payment of *** FICA and FUTA, but could well be inspired to file a claim for all open years to recover FICA and FUTA paid on the distributors' salaries and allocable to *all* services rendered. § 3121(c) of the Code in essence provides that if services performed during one-half of a pay period are exempt from employment taxes, then all services are exempt.

On the other hand, if we concede § 530 applies to the commission compensation, and grant an administrative settlement, the merits are never reached. It appears unlikely that the taxpayer, having taken the previously conservative position that salary payments were not within § 3121(b)(14)(B), would be emboldened to file a claim for the recovery of related FICA and FUTA taxes thereon, absent a favorable judicial decision on the merits.

Apr 24 1979

The Honorable M. Carr Ferguson
Assistant Attorney General
Tax Division
Department of Justice
Washington, D.C. 20530

In Re: ***
Your ref: MCF:MLS:BJHart 5-19-1556-CM
#7706878
5-19-1559-CM

Dear Mr. Ferguson:

This is in response to your letter dated March 28, 1979, requesting that we reconsider our position in the above-entitled case with regard to the availability of relief from liability for *** pursuant to section 530 of the Revenue Act of 1978. After considering the positions set forth both in your letter and in our conference on April 12, 1979, we agree with your recommendation of administrative settlement.

We agree that section 530 relief is applicable to controversies including I.R.C. sections 3121(b)(14)(B) and 3306(c)(15)(B) which except certain services from employment for FICA and FUTA purposes. To the extent that section 530 was enacted to relieve employers from retroactive assessments of employment tax liabilities, granting relief in this case is consistent with that purpose. A decision adverse to plaintiffs would result in an additional assessment of liabilities for employment taxes with regard to the commission wages.

Furthermore, we have concluded that plaintiff had a reasonable basis for not treating the rack salesmen as employees. Pursuant to a recommendation of an administrative refund in a case involving similar individuals employed by another newspaper, the Wages, Excise and Administrative Provisions Branch of the Individual Tax Division has determined that it is a long-standing recognized practice of a significant segment of

the newspaper industry to treat individuals such as these as independent contractors. (See also affidavit submitted with plaintiff's supplemental brief).

Under these circumstances, *** is entitled to relief pursuant to section 530. We recommend full administrative settlement in both the *** and *** cases.

Sincerely yours,

STUART E. SEIGEL
Chief Counsel

By: John C. Calhoun
Chief, Branch 1
Tax Litigation Division

United States v. Curtis (6th Cir. Jan. 28, 1986)

No. 85-5070

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

UNITED STATES OF AMERICA,
Plaintiff-Appellee,

v.

JAMES C. CURTIS,
Defendant-Appellant.

ON APPEAL from the United States District Court for the Eastern District of Kentucky.

Decided and Filed January 28, 1986

Before: KRUPANSKY and MILBURN, Circuit Judges; and JOINER, Senior District Judge.*

JOINER, Senior District Judge. This is the appeal of James C. Curtis from his conviction for income tax evasion pursuant to 26 U.S.C. § 7201. The appeal raises three questions: 1) the sufficiency of the evidence supporting the conviction; 2) the correctness of the jury instructions regarding the definition of income; and 3) the correctness of the trial judge's refusal to allow expert testimony and refusal to give an instruction on the unsettled and complex nature of the law.

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*Honorable Charles W. Joiner, United States District Court for the Eastern District of Michigan, Southern Division, sitting by designation.

Defendant was indicted on October 3, 1984, on three counts of income tax evasion for the calendar years 1978, 1979, and 1980. Count I of the indictment charged that for the year 1978, defendant reported adjusted gross income of $5,234 and paid taxes of $4, when his true adjusted gross income was $37,920.35 and the taxes due were $7,282.07. Count II of the indictment charged that defendant reported adjusted gross income of $4,773 for the year 1979 and paid no taxes, when he should have declared an adjusted gross income of $48,088.15 and paid $11,288.05 in taxes. Count III of the indictment charged that for the year 1980, defendant reported an adjusted gross income of $11,762 and paid $1,043 in taxes, when his true adjusted gross income was $63,208.43 and his tax liability was $20,325.27.

The charges against defendant arise from his operation of the Meat Shop, a wholesale meat retailer. Curtis is the president and sole shareholder of the business. Most of the Meat Shop's revenue comes from its sales of meat to the Fayette County Detention Center, which paid for its purchases by issuing monthly checks to the Meat Shop.

This case concerns portions of thirty-five checks from the Detention Center to the Meat Shop that Curtis deposited in his personal checking and savings accounts during 1978, 1979, and 1980. Curtis did not include this money as income when filing his individual tax returns. Instead, defendant declared only his salary from the Meat Shop, a small amount of income from a second job in 1978, and some interest income from the bank. The Meat Shop declared and paid taxes on all of its proceeds from the Detention Center, including the amounts Curtis deposited to his individual accounts, with one exception. That exception was a check dated May 17, 1978 in the amount of $5,381.14. Neither Curtis nor the Meat Shop declared that money as income.

During 1978, 1979, and 1980, Curtis also made some payments to the Meat Shop by writing checks or depositing his paychecks. The checks that defendant wrote back to the cor-

poration had the word "loan" written on them. The money Curtis paid to the Meat Shop was deducted from the Detention Center checks deposited in Curtis' accounts in calculating the undeclared amounts of adjusted gross income charged in the indictment.

Curtis maintains that the amounts that were transferred to his personal accounts were interest-free loans to him from the Meat Shop. He contends that the money he paid to the Meat Shop was in partial repayment of these loans. The government disagrees, arguing that Curtis received income from the corporation. According to the government, the checks Curtis wrote to the Meat Shop were initial loans from him to the corporation.

At the trial the government produced the relevant corporate and individual tax returns, and established the flow of money from the Detention Center to the Meat Shop and Curtis. The government called as its final witness an Internal Revenue Service field auditor who testified that in his opinion the money that Curtis received from the Meat Shop was taxable income.

The defendant called only one witness, a C.P.A. named David Wilkerson. He stated that the money that Curtis transferred to his personal accounts from the corporation "should have been accounted for as loans" which are not deductible by the corporation or taxable as income to the recipient. Wilkerson reasoned that the money could not be regarded as salary, for the corporation did not take a tax deduction for the amounts received by Curtis. The money also could not be deemed a dividend, for the corporation had no retained earnings and its balance sheet reflected no dividend payments. Wilkerson then stated that he could only conclude that the money was a loan from the Meat Shop to Curtis. He testified that such tax-free loans were common, and that they represented a tax planning opportunity.

The trial court submitted all of these matters as a part of the case to the jury, which convicted Curtis on all three

counts. Curtis now appeals his conviction on the several grounds indicated above.

I. Sufficiency of the Evidence

Curtis was convicted of three counts of violating 26 U.S.C. § 7201, which provides that:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony . . .

The Supreme Court has stated that there are three elements to the offense described by § 7201. The elements are: 1) willfullness; 2) the existence of a tax deficiency; and 3) an affirmative act constituting an evasion or attempted evasion of the tax. *Sansone v. United States*, 380 U.S. 343, 351 (1965). Curtis contends that in the present case, the government failed to show the existence of a tax deficiency, because no taxes were due. Specifically, Curtis argues that all that the government established at the trial was that the corporation had made certain amounts of money available to him. Defendant contends that this is insufficient to establish that he owes taxes on these amounts.

This case is governed by a prior decision of this court, *Davis v. United States*, 226 F.2d 331 (6th Cir. 1955), *cert. denied.*, 350 U.S. 965 (1956). Davis, like the defendant here, was the president and sole shareholder of a corporation. He converted checks made out to himself and the corporation for his personal use, and neither the corporation nor Davis declared that income on their tax returns. The court affirmed Davis' conviction for willfully attempting to evade and defeat tax, in violation of 26 U.S.C. § 146(b). In reaching this conclusion, the court reasoned that the money Davis took from the corporation should have been included in his gross income, as the money represented a gain to Davis. The *Davis* opinion found that gain constitutes income which should be declared on individual tax returns when

> its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. "That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it." *Rutkin v. United States*, 343 U.S. 130, 137, 72 S.Ct. 571, 575, 96 L.Ed. 833.

226 F.2d at 334.

Davis also addressed the appellant's argument that the trial court unjustifiably shifted the burden of proof of tax evasion from the government to him:

> As for the claim that the trial court erred in placing upon appellant the burden of explaining that the gross receipts of his corporation did not constitute taxable income of appellant, the court did not thrust such a burden upon him. While, of course, the burden of proof does not shift in a criminal case, it is the rule that when the government establishes a prima facie case, it is then for the defendant to overcome the inferences reasonably to be drawn from the proven facts. Thus, evidence of unexplained funds or property in the hands of a taxpayer establishes a prima facie case of understatement of income, and it is then incumbent on him to overcome the logical inferences to be drawn from such proof. . . . (I)f a man has a business of a lucrative nature and is constantly receiving money and depositing it to his own account and using it for his own purposes, this is proof that he has income, and if the amount exceeds exemptions and deductions, that the income is taxable.

Id. at 335-36 (citations omitted).

In the present case, as in *Davis*, the government established that defendant took money from the corporation and deposited it to his personal account. Curtis presented no evidence that he had an obligation to repay the corporation for the money he received. He thus failed to overcome the logical inference to be drawn from the government's evidence, which was that the money was income to Curtis.

Curtis distinguishes *Davis* on the grounds that the Meat Shop declared and paid taxes on the money in dispute here, whereas the corporation in *Davis* did not declare or pay taxes on the disputed funds. Curtis also argues that the Meat Shop's tax returns and balance sheets indicate that the money could not have been salary or dividends to him, so that the money must be regarded as a loan.

With these arguments, Curtis attempts to focus the attention of this court on the activities of the Meat Shop and away from his own activities. This approach was squarely rejected in *Davis*:

> Appellant contends in this case that, whether the cash which he took from his wholly owned corporation was a "taxable gain," depends upon whether the corporation had sufficient surplus to cover a dividend distribution, as otherwise there would be no way in which he could receive such cash as a gain taxable to him and, since there is no proof of such a surplus, he is only a holder of the cash for the benefit of the corporation. However, it does not make any difference whether he received it as a legal distribution of cash as the result of a dividend, or whether he took it fraudulently .... For "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378, 50 S.Ct. 336, 74 L.Ed. 916. It is the command over property and

> the enjoyment of its economic benefit which are recognized as a proper basis of taxation.
>
> . . . .
>
> Appellant makes much of the fact that the government has not fixed a label of some kind on the funds that he took from his corporation. It is not necessary to describe them as additional salary, illicit bonuses, or commissions, or anything more than wrongful diversions, since, as above mentioned, substance controls over form, and taxation is concerned with the actual command over the property taxed.

Id. at 334-35 (citations omitted). *Davis* thus holds that an individual has received income when he gains complete dominion and control over money or other property, thereby realizing an economic benefit. It does not matter what the money represents from the standpoint of the corporation.

The court finds that *Davis* should be applied to the present case. *Davis* clearly establishes that the government presented sufficient evidence of the existence of a tax deficiency to support Curtis' conviction.

II. Challenges to the Jury Instructions on the Definition of Income

Curtis next objects to two of the instructions given by the trial court. The first of the two instructions, number 20, is taken from *Davis v. United States, supra.* It reads:

> Income received from any source constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it, and that this occurs when cash is received by an individual in a manner which allows him freedom to dispose of it or use it at will.

Defendant argues that instruction 20 contradicts instruc-

tion 19, which describes the calculations of gross income, adjusted gross income, and taxable income.[1] Curtis contends that instruction 20 should not say that income received from any source constitutes "taxable income." Instead, instruction 19 correctly states that "taxable income" is the sum remaining after deductions and exemptions are subtracted from adjusted gross income.

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[1]Instruction 19 reads as follows:

> The first step in arriving at the income of an individual upon which the tax is imposed is a determination of the gross income of the individual. Gross income generally means all income from whatever source derived including (but not limited to) compensation for services, including fees, commissions, and similar items; gross income derived from business; gains from dealings in property; and interest and dividends.
>
> After having determined the gross income of an individual, the next step provided by the statutes for arriving at the income upon which the tax is computed is to subtract from the gross income such deductions as the statutes permit. That is, an individual is permitted to deduct from gross income all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business or other profit-seeking endeavors, including (but not limited to) salaries paid to employees, rentals for property used in the business, and for certain losses, not reimbursed by insurance, incurred in the trade or business of other profit-seeking endeavors.
>
> The amount remaining after subtracting the allowable deductions from gross income is termed adjusted gross income. Then, in determining taxable income the taxpayer is first permitted to deduct from adjusted gross income either the optional standard deduction fixed by law or, in the alternative, the amounts paid during the year for certain purposes limited by law, such as for charitable contributions, interest, taxes, medical expenses, casualty losses, and other items not pertinent here. Then finally, the taxpayer is allowed a deduction of $750.00 for 1978 and $1,000.00 for 1979 and 1980 for each qualified exemption. The resultant figure is termed taxable income, that is to say the sum on which the income tax is levied.

Curtis also argues that instruction 20 contradicts instruction 21, which states that loans do not constitute income.[2] He refers specifically to the last portion of instruction 20, which states that taxable income occurs "when cash is received by an individual in a manner which allows him freedom to dispose of it or use it at will." Curtis maintains that instruction 20 labels every receipt of unrestricted cash, including loans, as income. This allegedly contradicts the statement in instruction 21 that loans are not income.

"In reviewing a trial judge's instruction to a jury, we must look at the charge as a whole and we will not reverse unless the instruction as given had a tendency to confuse or mislead the jury." *Farace v. Independent Fire Ins. Co.*, 699 F.2d 204, 297 (5th Cir. 1983) (citations omitted); *Carruba v. Transit Casualty Co.*, 443 F.2d 260, 264 (6th Cir. 1971). After reviewing instruction 20 in the context of its surrounding instructions, the court concludes that it must be affirmed. The instructions, taken as a whole, are not misleading or otherwise prejudicial. Instruction 21 clearly states that interest-free, undocumented loans from corporation to shareholder are properly excluded from the gross income of the share-

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[2]Instruction 21 states that:

> Loans or advancements do not constitute gross income as that term is defined by the Internal Revenue Code. Likewise, a return of capital invested in a corporation by a stockholder does not constitute gross income.
>
> The law, for the tax years in question, did not require the taxpayer to maintain any specific form of written documentation for loans from or to his corporation and the law did not require the taxpayer or the corporation to charge interest to the other for such loans. Likewise, for the years in question, it was not illegal for the taxpayer to make loans to his corporation or for the corporation to make loans to him. If you find from the evidence that the portion of the receipts received by Mr. Curtis for the years in question constitute loans, advancements, or a return of capital invested, you are instructed that such receipts do not constitute taxable income.

holder, and instruction 20 does not contradict or obscure this instruction. While the trial court might have been more careful about its use of the term "taxable income," it did not commit reversible error, for the jury was flatly given a correct statement of the law as it relates to receipt of loans.

Curtis also challenges the following instruction:

> The funds from the Lexington Fayette County Urban Detention Center in question were received in the first instance by The Meat Shop, Inc., of which the defendant, James C. Curtis, was president and sole stockholder. You are further instructed that such money received by a corporation is not income to an individual unless the corporation funds are in some way transferred or diverted to the individual, and become property over which he exercises dominion and control and treated as his own, to the exclusion of any interest therein by the corporation.
>
> If you find beyond a reasonable doubt that James C. Curtis, as the sole owner of The Meat Shop, Inc., diverted funds of that corporation to himself personally, and exercised control over them and treated them as his own, that would constitute taxable income that he was required by law to include in his income tax return.

Defendant once more objects to the instruction on the grounds that it tells the jury to find taxable income whenever a person receives cash over which he has control. Again, Curtis' argument must fail. The challenged instruction states that the jury may conclude that Curtis received income from the Meat Shop only if he held the money "to the exclusion of any interest therein by the corporation." This phrase comports with the statement in instruction 21 that Curtis did not receive income from the Meat Shop if the money was a corporation loan. The court concludes once again that the instructions, read as a whole, did not prejudice Curtis and should be affirmed.

III. The Law as Unsettled or Complex

At the close of the government's case, it moved *in limine* to exclude the testimony of a defense witness who was proffered to testify that the area of tax law governing the treatment of corporation distributions to shareholders was unsettled and complex. The trial court granted the motion, holding that defendant could not present this evidence unless he could establish that he was confused or had relied on the expert's advice. The defense acknowledged that it could not make this showing. Curtis now complains that the trial court's ruling unjustifiably deprived him of a defense on the issue of the willfulness of his conduct.

Defendant also objects to the trial court's refusal to give his proposed instruction number 13-B. This instruction tells the jury that it may consider the unresolved nature of the tax law in determining whether defendant willfully evaded taxation. The instruction also states that if the jury finds the law to be unsettled or complex, then defendant lacked the requisite intent to violate the law, regardless of whether or not defendant knew of the legal uncertainty.[3]

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[3]Defendant's proposed instruction 13-B reads as follows:

> There has been testimony relating to the unsettled nature of the law pertaining to those transactions which are non-taxable events, such as loans and repayments of loans, returns of capital, and those transactions which are taxable events and comprise forms of income such as salary or constructive dividends.
>
> I instruct you that when the characterization of such amounts is problematical, as a matter of law, the unresolved nature of the law is relevant to show that the Defendant may not have been aware of the responsibility to report an item or may simply have made an error in judgment. Furthermore, the relevance of a dispute in the law does not depend on whether the Defendant knew of the conflict. If you determine that this area of the tax law relating to loans, returns of capital, and constructive dividends is vague, unsettled, complex or debatable, then, as a matter of law, the Defendant lacks the requisite intent to violate the law and therefore cannot be found guilty of willfully underreporting such items, the taxability of which is so uncertain and problematical.

Curtis' objections to the trial court's granting of the motion *in limine* and to its refusal to give proposed instruction 13-B are based primarily on *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979). The defendant in *Garber* received over $200,000 for allowing medical suppliers to extract rare antibodies from her blood. Mrs. Garber failed to report the payments she received for her blood components, and she was convicted for willfully attempting to evade federal income tax for 1970, 1971, and 1972.

At the time Mrs. Garber was prosecuted, no court or agency had ever decided whether payments for blood donations are income that is subject to taxation. Mrs. Garber argued in the trial court that she could not have willfully evaded the tax because the law was unsettled. She offered to call an expert witness to testify that the tax treatment of the blood sale proceeds was a novel and uncertain question. The trial judge refused to allow this testimony, describing the issue of taxability and legal uncertainty as matters of law for the judge. Based on the extensive evidence taken on Mrs. Garber's state of mind, other than evidence concerning the status of the tax law, the jury convicted her.

The Fifth Circuit reversed Mrs. Garber's conviction, finding that the trial court mistakenly "reserved to itself the job of unriddling the tax law." 607 F.2d at 97. The court held that a jury deciding whether a defendant acted willfully may consider the uncertain state of the law, as revealed by expert testimony, as evidence of the defendant's state of mind. Moreover, the court declared that "the relevance of a dispute in the law does not depend on whether the defendant actually knew of the conflict." *Id.* at 98. It reasoned that even if defendant had consulted the law, she would not and could not have discovered how to comply with it. *Id.* The court concluded with the observation that "[a] criminal proceeding pursuant to section 7201 is an inappropriate vehicle for pioneering interpretations of tax law." *Id.* at 100.[4]

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[4]The Fifth Circuit appears to have retreated from the sweeping language used in *Garber*, however. In *United States v. Burton*, 737 F.2d

After carefully reviewing *Garber* and other cases, this court declines to follow and rejects *Garber* for several important reasons. First, *Garber* allows juries to find that uncertainty in the law negates willfulness even when the defendant is unaware of that uncertainty. This contradicts the prior cases on willfulness, which "consistently require factual evidence of the defendants' state of mind to negate willfulness under any theory." *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 97 (2d Cir. 1983), *cert. denied*, 462 U.S. 1131 (1983); Note, *Criminal Liability for Willful Evasion of an Uncertain Tax*, 81 Colum.L.Rev. 1348, 1357 (1981). Willfulness is personal. It relates to the defendant's state of mind. It does not exist in the abstract. Unless there is a connection between the external facts and the defendant's state of mind, the evidence of the external facts is not relevant.

Second, the *Garber* approach distorts the role of expert witnesses and the purpose of their testimony. Expert testimony is intended to "assist the trier of fact to understand the evidence or to determine a fact in issue . . ." Fed.R.Evid. 702. *See also Garber, supra*, at 106 (Ainsworth, J., dissenting). Experts are supposed to interpret and analyze factual evidence. They do not testify about the law because the judge's special legal knowledge is presumed to be sufficient, and it is the judge's duty to inform the jury about the law that is relevant to their deliberations. *See Marx & Co. v. Diners'*

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439 (5th Cir. 1984), the court affirmed the lower court's refusal to allow testimony from a tax professor that defendant's theory of taxation was plausible but not legally accepted. The Fifth Circuit found that evidence of legal uncertainty need not generally be received in cases where the defendant was unaware of the law. Such evidence is admissible only in cases involving a level of uncertainty "approaching legal vagueness," or in cases addressing a "novel or unusual application of the law." 737 F.2d at 444. The court summarized its reading of *Garber* as follows: "In short, we read *Garber* no more broadly than its facts in deciding that in other cases the judge will ordinarily be the sole source of the law." *Id.*

Club, 550 F.2d 505, 509-510 (2d Cir. 1977), *cert. denied*, 434 U.S. 861 (1977); Note, *supra*, at 1362. The *Garber* approach also creates problems for the jurors listening to expert testimony. Jurors might be confused by opposing opinions of law offered by different experts. *See United States v. Ingredient Technology Corp.*, 698 F.2d at 97. *Garber* would also force jurors to take their instructions on the law from expert witnesses as well as from the trial judge. Any differences in the legal rules given by the expert and the judge would be another potential source of confusion.

Finally, and perhaps most significantly, *Garber* requires the jury to assume part of the judge's responsibility to rule on questions of law. *Garber* asks the jury to read and interpret statutes to determine whether or not the governing law is uncertain or debatable. This function has traditionally belonged to the judge, as:

> The jury is not composed of lawyers; the typical juror is untrained in legal affairs. To attempt to explain the myriad rules of judicial construction, the complexity of legal principles, or the function of precedent would hopelessly divert the jury from their preeminent duty of assessing appellant's guilt.

Garber, supra, at 105 (Ainsworth J., dissenting). *See also United States v. Mallas*, 762 F.2d 361, 364 n.4 (4th Cir. 1985).

The trial court in the present case properly granted the government's motion *in limine* and properly refused to give defendant's proposed instruction 13-B. For each of the reasons set out earlier in this case, evidence of the unsettled or complex nature of the law is irrelevant, and instructions to the jury on this subject are not proper.

Defendant's conviction is affirmed.

District Court Ruling on Post-Trial Motion

UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

CRIMINAL NO. B83-46

UNITED STATES OF AMERICA

v.

DAVID H. MACKENZIE, INC., ET AL.

RULING ON DEFENDANTS' POST-TRIAL MOTIONS

After an eleven-week criminal trial resulting in convictions of all four defendants on all of the counts with which they were charged,[1] three of the four defendants have moved for a new trial and for a judgment of acquittal. The motions are denied for the reasons below.

A. MOTION FOR JUDGMENT OF ACQUITTAL

Defendants David H. MacKenzie, Inc., Roderick J. MacKenzie and Malcolm L. MacKenzie have moved for a judgment of acquittal on the grounds, first, that the statutes at

1 Defendant David H. MacKenzie, Inc. was charged with and convicted of Count One, conspiracy. Defendant Roderick MacKenzie was charged with and convicted of seventeen counts: one conspiracy count, eleven filing of false return counts and five aiding and assisting counts. Defendant Malcolm MacKenzie was charged with and convicted of one conspiracy count and five aiding and assisting counts. Defendant James Auger was charged with and convicted of one conspiracy count and one count for filing a false return.

issue are unconstitutionally vague as applied to employers involved in a controversy with the Internal Revenue Service (I.R.S.) over workers status and, second, that the passage of Public Law 95-600, § 530, requires the court to impute to Congress an intention to abate criminal prosecutions involving such worker status controversies.

1. *Vagueness*

Defendants argue that the uncertainty in the common-law definition of employee and the inconsistencies in the terms in the Internal Revenue Code, Chapters 21 (FICA) and 24 (income tax withholding), have deprived them of the constitutionally-required notice of the behavior that would constitute a criminal violation of the withholding statutes, and lends itself to arbitrary enforcement. They cite ample authority for the proposition that, using the common-law test, reasonable minds could differ as to who is an employee and who is an independent contractor in a given situation. *See e.g. Hoosier Home Improvement Company* v. *United States*, 350 F.2d 640 (Cl. Ct. 1965). Certainly this court does not dispute that this area of the tax law has spawned many controversies. Nevertheless, the court concludes that the statutes at issue in this prosecution are not unconstitutionally vague.

There is a significant difference between a statute that "fails to give a person of ordinary intelligence fair notice that his contemplated conduct is forbidden by the statute," *United States v. Harris*, 347 U.S. 612, 617 (1954), and a statute that establishes standards the application of which by reasonable persons might produce different results. In the present case, the determination of whether a worker is an employee or an independent contractor is made by assessing the degree of control the taxpayer has the right to exercise over the worker. 26 C.F.R. § 31.3401(c)-1. There are generally-accepted factors that aid in this determination. Defendants do not dispute what these factors are. Rather, they argue that an unconstitutional level of uncertainty is introduced by the fact that reasonable persons might weigh those factors and conclude differently.

As an example of persuasive reasoning, defendants cite *State v. Bucciarelli*, 10 Conn. Law Trib. 11 (Dec. 24, 1984), where Judge Emmett emphasized the potential for arbitrary enforcement as the reason for finding a statute vague for the purposes of a criminal prosecution. The statute, Conn. Gen. Stat. § 29-306, had required a person to remedy fire code violations "within a reasonable period of time as specified by the local fire marshal." Judge Emmett found the statute impermissibly permitted " 'a standardless sweep [that] allows policemen, prosecutors and juries to pursue their personal predilections.' " 10 Conn. Law Trib. at 15, quoting *Kolender v. Lawson*, 461 U.S. 352 (1983). The weighing of specific and commonly-accepted factors by the jury is far less uncertain and open to arbitrary enforcement than a determination of what is "reasonable". Moreover, in *United States v. Ragen*, 314 U.S. 513 (1942), the Supreme Court upheld a conviction, challenged on vagueness grounds, for willful evasion of federal income taxes because defendant had deducted more than "reasonable" allowances for salaries. The Court stated that "[t]he mere fact that a penal statute is so framed as to require a jury to determine a question of reasonableness is not sufficient to make it too vague to afford a practical guide to permissible conduct." 314 U.S. at 523. In light of *Ragen*, the case at hand hardly presents "a standardless sweep."

Beyond the fact that the court finds that the common-law factors constitute a sufficient "practical guide", the statutory requirement of willfulness precludes a finding of vagueness when applied to these defendants. The jury must necessarily have found that the defendants intentionally violated a known legal duty. "A mind intent upon willful [violation] is inconsistent with surprised innocence." *United States v. Ragen*, 314 U.S. at 524.

This is not to say that all specific intent crimes are inherently immune from a vagueness attack. The Court has noted that "[t]he requirement that the act must be willful or purposeful may not render certain, for all purposes, a statutory definition of the crime which is in some respects uncertain." *Screws v.*

United States, 325 U.S. 91, 102 (1945). However, it is generally true that when punishment is imposed "only for an act knowingly done with the purpose of doing that which the statute prohibits, the accused cannot be said to suffer from lack of warning." *Id.*

Because the conviction of these defendants involved a constitutionally-acceptable degree of weighing of the common-law control factors by the jury and required a finding that they had acted willfully, the defendants did not suffer from a lack of warning from or arbitrary enforcement of an unconstitutionally-vague statute.

2. *Abatement*

Defendants maintain that this court must impute to Congress an intent to abate all criminal prosecutions for violations of the withholding laws where a controversy over the status of the workers exists. Relying on *Hamm v. City of Rock Hill*, 379 U.S. 306 (1964), they argue this is so in spite of the fact that the legislative history of Public Law 95-600 § 530 is silent on its application to criminal proceedings.

The legislative history of § 530 indicates that Congress was concerned with the change in the way the I.R.S. was classifying individual workers. S. Rep. No. 1263, 95th Cong., 2d Sess., *reprinted in* 1975 U.S. CODE CONG. & AD. NEWS 6972.[2] In the civil assessment context, employers, who were civilly liable for technical violations even if their misclassification was innocent, were being assessed large sums of money for retroactive withholding. While offsets for the taxes paid by the employees directly were theoretically possible, in reality it was of little assistance to the employers. Congress therefore created a temporary "safe haven" for particular employers who met carefully prescribed criteria, relieving them of liability for these back taxes. Section 530 also operates prospectively, deeming

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2 The Senate Report is persuasive on this point even though the Senate version of § 530 was different from the final version that was passed in some of the specific ways a taxpayer could qualify from the protections. *See Ridgewell's Inc. v. United States*, 655 F.2d 1098, 1104 (Cl. Ct. 1981).

certain employees to be "non-employees" until such time as Congress legislates further in this area of worker status. Again, § 530 offers relief to certain employers only, and it is clear that Congress did not intend to excuse those who intentionally disregard the laws or act fraudulently. S. Rep. No. 1263, 95th Cong., 2d Sess., *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS, at 6974.

The language and structure of § 530 indicates that it was envisioned for application in a civil context: The employer is given a number of ways to demonstrate that he qualifies for the protections of § 530. Of course, defendants are correct that the inquiry into whether the court should tailor § 530 to fit a criminal prosecution does not end here. There is an appealing logic to the argument that if Congress meant to terminate liability in the civil context because of its dissatisfaction with worker status controversies, surely it meant to abate criminal prosecutions in the same areas. The fallacy with the argument is that it fails to recognize that § 530 is not needed in the criminal realm. In a criminal prosecution, it is the government that bears the burden of persuasion and unlike a civil assessment case, the government must prove that the failure to withhold was an intentional violation of a known legal duty. If the facts are present to support a criminal conviction, defendants would not qualify for § 530 protections, given the good faith requirement.

Congress' concern that innocent taxpayers not be caught in a change of I.R.S. policy is more than adequately addressed by the heightened burdens on the government in a criminal prosecution. A congressional intention to clarify and simplify the area of worker status classifications is simply not inconsistent with the prosecution of the intentional and purposeful violations of the known legal duty to withhold FICA and income tax for workers known to be one's employees.[3]

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3 Since the passage of § 530, there has been at least one other prosecution involving the employee-independent contractor distinction. *See United States v. McLaughlin*, 663 F.2d 949 (9th Cir. 1981). The Ninth Circuit did not even question the propriety of such a prosecution. Even though the

B. MOTION FOR NEW TRIAL

Defendants have moved for a new trial because they contend the jury instructions were erroneous and prejudicial to them in five areas. All five issues were the subjects of argument, conferences and written submissions by both sides during the course of the trial. The court supplements its position already on the record on the five subjects as follows.

1. *Section 530*

A continuing controversy in this case has been whether the court was required to instruct the jury that its determination of whether defendants owed a duty to withhold depended on the application of Public Law 95-600, § 530. The defendants' position has been that § 530 "redefines" the taxpayer's reporting and withholding obligations. The court found, however, that § 530 is a forgiveness or a safe haven, terminating tax liability for some qualified employers by allowing them to treat employees as non-employees if there is a reasonable basis for doing so. H. Conf. Rep. No. 1800, 95th Cong. 2d Sess., *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS, 7266. Given this perspective, the court decided that the highly complex and confusing specifics of § 530 need not be included in the instruction because defendants received even greater protections from the willfulness requirement than they would from a § 530 instruction.

Under § 530, a taxpayer must have a reasonable basis for treating an employee as a non-employee. Reasonableness is an objective test. Thus, if the defendants did not know their workers were employees but they had no reasonable basis for their improper treatment, § 530 would offer no safe haven. Only the willfulness requirement would save defendants in such a situation. And, because the legislative history of § 530

Court of Appeals was apparently incorrect as to whether the jury had been instructed on § 530, it was obviously aware of the section and had it within its power to vacate the conviction if it found that § 530 was evidence of a congressional intent to abate the prosecution of cases involving worker status controversies.

makes it clear that Congress did not extend a safe haven to anyone who intentionally disregards regulations or commits fraud, 1978 U.S. CODE CONG. & AD. NEWS at 6973-4, defendants could not benefit from § 530 if they subjectively knew they were wrong but their position was objectively reasonable or tenable.

Given the protections afforded the defendants from the requirement that the government prove their conduct was willful, there was no additional benefit to defendants from a § 530 instruction. The court therefore declined to instruct the jury on § 530.

2. *Guilty Knowledge*

Defendants argue that the court's incorporation of a "guilty knowledge" instruction, essentially that of § 14.09, Devitt and Blackmar, Federal Jury Practice and Instructions, diluted the requirement that the government prove defendants had actual knowledge of their obligations under the tax code.

The court's instruction did not imply that defendants had a duty to investigate the law, as they contend. Rather, it informed the jury that in determining whether defendants acted knowingly, they might infer actual knowledge from a deliberate closing of one's eyes.

Knowing behavior is an element of willful behavior. The court recognizes that willfulness cannot be equated with recklessness and for this reason cautioned the jury that "mistake, negligence, carelessness, recklessness or gross negligence" would not support a finding of either willfulness or knowledge. Defendants' citations to cases in other contexts where courts have defined "reckless disregard for the law" as the deliberate closing of one's eyes do not dictate otherwise. *See e.g. United States v. Ottley*, 509 F.2d 667 (2d Cir. 1975) (labor law).

In this tax prosecution, as in many other types of criminal prosecutions, the government was required to prove the defendants had actual knowledge of their legal duty and the jurors were instructed accordingly. They were also instructed in accordance with the accepted practice that a deliberate and

conscious purpose to avoid knowing what the law required can, in certain circumstances, constitute evidence that defendants had the requisite actual knowledge. Such deliberate conduct cannot be, and was not, equated in this context with "mere" reckless conduct.

3. *Motive vs. Intent*

The defendants argue that the court's instruction on motive and intent was erroneous and prejudicial because of their defense that their object in issuing the separate checks was only to pay workers below the union wage scale, a legal purpose.

After instructing the jury that the state of mind they had to find in order to find defendants guilty was willful and knowing, the court cautioned the jury not to confuse "motive", which is what prompts a person to act or fail to act, with "intent" which is the state of mind with which the act is done. Similarly, in the context of the conspiracy count instructions, the jury was told that the members conspiracy may have their own motives or reasons for joining the conspiracy, but whatever their own reasons, they must have combined to effect the purpose alleged in the indictment. The court told the jury that good motive alone is not a defense, but it might be an aid in determining the state of mind. This instruction is in accordance with *United States v. Pomponio*, 428 U.S 10 (1976), where the Supreme Court upheld a tax conviction with the identical instruction. In *Pomponio*, the Court held that no "evil purpose" is required for a 26 U.S.C. § 7206(1) conviction other than the specific intent to violate the law. Therefore, this court properly instructed the jury that if it found defendants had intended to violate the tax laws, even if with a legal and laudable goal, they could be found to have acted with the requisite state of mind, i.e., willfully.

4. *Confusion in the Law*

The defendants' position that the jury should have been instructed on the confusion in this area of the tax laws is consistent with their position at trial that they should be

allowed to cross-examine the I.R.S. agents and elicit expert testimony to the effect that this is a confusing area of law. The court declined to allow such testimony and declined to instruct the jury in such specific terms. Relying on *United States v. Ingredient Technology Corp.*, 698 F.2d 88, 97 (2d Cir. 1983), the court determined that the critical issue was the defendants' actual state of mind and that it was a factual question for the jury to determine whether defendants acted willfully and with knowledge of their duty to withhold. The essence of defendants' position that defendants had to be aware of their obligations, even given the complexities of the tax code, was adequately embodied in the court's knowing and willful instructions. The fact that defendants presented testimony that was not believed that they did not know what the law required of them in no way undercuts the sufficiency of the court's instruction.

5. *Reinstruction*

During its deliberations, the jury requested that the court reread two of the three statutes charged in the indictment, 18 U.S.C. § 371 and 26 U.S.C. § 7206(1). (Court Ex. 17). Prior to doing so, the court informed counsel for the government and the defendants of the jury's request. Defendants' counsel maintained that the court should read more than just the statutes themselves, requesting that the portion of the instructions that included the definitions of the elements of the offenses also be reread to the jury. Because the jury had been fully instructed at great length on each element in the initial instruction and had only asked for the statutes themselves to be reread, the court decided it was appropriate, sufficient and fair simply to reread the two statutes. Defendants' citations to cases where prejudice to the defendant was found involved initial instructions, not reinstructions, and are inapposite. Just as with initial instructions, however, the legal sufficiency of a supplemental charge must be assessed in the context of the instructions as a whole. *United States v. Toner*, 728 F.2d 115, (2d Cir. 1984); *United States v. Velez*, 652 F.2d 258 (2d Cir.

1981). The court did not omit any elements in its reinstruction nor did it define some of the elements to the exclusion of others, thereby placing undue emphasis on some of the elements. *See e.g. Velez*, 652 F.2d at 262. Viewed in the context of the exhaustive explanation of each essential element in the initial instruction, the rereading of the statutes alone cannot have been prejudicial to the defendants.

CONCLUSION

For the foregoing reasons, the court denies the motions for a new trial and for a judgment of acquittal made by defendants David H. MacKenzie, Inc., Roderick J. MacKenzie and Malcolm L. MacKenzie.

SO ORDERED.

/s/ Ellen B. Burns
ELLEN BREE BURNS
UNITED STATES DISTRICT JUDGE

Dated at New Haven, Connecticut, this 16th day of January, 1985.

District Court Ruling on Bail Pending Appeal

UNITED STATES DISTRICT COURT
DISTRICT OF CONNECTICUT

CRIMINAL NO. B83-45

UNITED STATES OF AMERICA

—v.—

DAVID H. MACKENZIE, INC., ET AL

RULING ON DEFENDANTS' APPLICATION FOR BAIL PENDING APPEAL

On January 17, 1985, sentences of incarceration were imposed upon defendants Roderick J. MacKenzie and Malcolm MacKenzie. The effective sentence for Roderick was thirty days and for Malcolm, six months. At that time, the court found that defendant has shown by clear and convincing evidence that neither defendant posed a risk of flight and therefore granted their requests for voluntary surrender at the institution. The date set for such surrender was February 19, 1985.

On January 24, 1985, defendants filed notices of appeal. On January 29, 1985, both defendants moved this court for bail pending appeal, advancing three grounds: (1) that application of the Bail Reform Act of 1984 is precluded by the *ex post facto* clause of the the United States Constitution; (2) that even if the 1984 Act is applied, defendants have met their burden under 18 U.S.C. § 3143(b); and (3) that because of the short duration of the sentences, denial of bail would deprive

defendants of due process by making their appeal moot. The court disagrees with defendants' *ex post facto* argument, but because defendants have met their burden under § 3143(b), their third argument is not reached and the motion is granted.

EX POST FACTO CLAIM

Defendants are alleged to have committed the offenses of which they have been convicted in 1976 to 1979. The Bail Reform Act of 1984 became effective on October 12, 1984, establishing a new and much stricter test for the availability of bail pending appeal.

Nonetheless, the application of the new standard does not constitute a violation of the *ex post facto* clause. The *ex post facto* prohibitions apply to punishment, not to a procedural change, even if the change is disadvantageous to the defendant. *See Weaver v. Graham*, 450 U.S. 24 (1981); *Dobbert v. Florida*, 432 U.S. 282 (1977). This court agrees with the Third Circuit that "the availability *vel non* of bail pending appeal, albeit extremely important to the individual involved, is a procedural issue rather than a type of punishment. . . ." *United States v. Miller*, Nos. 84-1733 and 84-1734 (3d Cir. Jan. 18, 1985), slip. op. at 4.

SECTION 3143(b)

The Bail Reform Act of 1984, 18 U.S.C. § 3143(b), states in relevant part that a person found guilty and sentenced to a term of imprisonment shall be detained unless the judge finds:

(1) by clear and convincing evidence that the person is not likely to flee or pose a danger to the safety of any person or the community if released . . . ; and

(2) that the appeal is not for the purpose of delay and raises a substantial question of law or fact likely to result in refersal or an order for a new trial.

As stated earlier, the court has already found, and continues to find, that defendants have established by clear and convinc-

ing evidence that they are no danger to anyone, nor are they likely to flee. Regarding subsection (2), however, the court again agrees with the Third Circuit in *Miller* that the language simply cannot mean what it appears to mean. If a court could grant bail only upon the finding that it is "likely" that its own rulings would be reversed, the privilege of bail pending appeal would cease to exist. A district judge would have either to grant a new trial or deny bail. In this case, the court denied defendants' motions for a new trial and for judgment of acquittal on January 16, 1985. Yet, the court recognizes that this case presents difficult legal questions. Accordingly, the court adopts the *Miller* reasoning upon which the parties in this case agree, that § 3143(b)(2) must be construed to read first, that the appeal must raise a substantial question of law or fact and second, *if defendants prevail on the appeal*, the issue is likely to result in reversal or new trial. *Miller*, slip. op. at 9.

The government takes issue with whether defendants' appeal raises substantial questions. In spite of the court's belief that it finally resolved the P.L. 95-600 § 530 issues properly, there was very little authority on the question and much controversy was generated. The court recognizes that competent legal minds may disagree on the § 530 question. The fact that one other identifiable case for separate check/failure to withhold tax violations had been prosecuted does not save this issue from being "novel." *See United States v. McLaughlin*, 663 F.2d 949 (9th Cir. 1981). The § 530 issue was addressed in a very cursory fashion in *McLaughlin*. Indeed, a review of the jury instructions given in that case reveals that § 530 was never mentioned, weakening the strength of the Ninth Circuit's statement that "there is ample evidence on the record to support the jury's rejections of [defendant's] § 530 defense." 663 F.2d at 952. Accordingly, the court finds that the defendants' appeal raises a substantial legal question.

Moreover, if defendants prevail, it would not be harmless error. Section 530 impacts on virtually every count of the indictment, particularly if the Second Circuit were to find that Congress intended an abatement of all such prosecutions.

The court concludes, therefore, that defendants have satisfied each element of § 3143(b). Accordingly, defendants are not required to surrender at the institution on February 19, 1985, but are admitted to bail during the pendency of their appeal, under the same terms and conditions already in effect.

SO ORDERED.

/s/ Ellen B. Burns
ELLEN BREE BURNS
UNITED STATES DISTRICT JUDGE

Dated at New Haven, Connecticut, this 16th day of January, 1985.

Supreme Court, U.S.
FILED
MAY 15 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-1405

In the Supreme Court of the United States

OCTOBER TERM, 1985

RODERICK J. MACKENZIE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether petitioners lacked the intent to violate the tax laws because of uncertainties in the legal standards for classifying workers as employees or independent contractors.

2. Whether Section 530 of the Revenue Act of 1978 protects petitioners from criminal prosecution for failing to withhold taxes from their workers' wages.

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OPINION BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 777 F.2d 811.

JURISDICTION

The judgment of the court of appeals was entered on November 20, 1985. A petition for rehearing was denied on January 21, 1986 (Pet. App. 25a). The petition for a writ of certiorari was filed on February 21, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Following a jury trial in the United States District Court for the District of Connecticut, petitioners David H. MacKenzie, Inc., Roderick J. MacKenzie and Malcolm MacKenzie were convicted of conspiracy to defraud the United States under 18 U.S.C. 371; Roderick MacKenzie

was convicted on eleven counts of making and subscribing false employer's quarterly tax returns under 26 U.S.C. 7206(1); and Roderick and Malcolm MacKenzie were convicted under 26 U.S.C. 7206(2) on five counts of aiding and assisting the filing of false employee's tax returns. David H. MacKenzie, Inc., was sentenced to a $10,000 fine. Roderick MacKenzie was sentenced to a $10,000 fine, three years' imprisonment with all but 30 days suspended on the conspiracy count, and one year's probation on each of the other counts, all to run concurrently. Malcolm MacKenzie was sentenced to three years' imprisonment with all but six months suspended, and two years' probation on each count, all to run concurrently. Pet. App. 3a-4a.

1. During the period at issue, petitioner Roderick MacKenzie was president, and petitioner Malcolm MacKenzie, his son, was general manager of petitioner David H. MacKenzie, Inc. That company is a family painting business that employs full-time painters pursuant to a union contract with the Painters and Allied Trades Union (Tr. 94-97, 6455).[1] Beginning around 1970, the company contracted to have the Citytrust Bank of Bridgeport, Connecticut, prepare its computerized payroll checks. The bank arranged to hold the company's withholding taxes and prepare W-2 forms for its individual employees. The company calculated the employees' wages by applying the union wage rates to the hours reported on the employees' daily timesheets. That information was then forwarded to Citytrust Bank for preparation of the payroll. Tr. 104-111, 1581-1583.

In 1975, the company began to use a system of paying workers for some work without withholding taxes. Those payments were made by checks separate from the payroll

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[1]Trial transcript references are taken from the government's brief in the court of appeals.

checks prepared by the bank. Tr. 139-142. The company first used this system to pay two union employees for work they did on a piecework basis rather than by the hour. The two employees accepted payment on this basis at the request of petitioners Roderick and Malcolm MacKenzie. Tr. 3091-3093, 3098-3102. The company next used the same system in paying several workers, including petitioner Malcolm MacKenzie and his brother, David MacKenzie, for their work on weekend painting jobs at less than the union scale (Tr. 3110-3116).

In July 1976, the use of the non-withholding system spread to a majority of the union employees. Petitioner Roderick MacKenzie and James Auger, the shop superintendent, informed the employees that overtime would thereafter be paid at less than the time and one-half rate required by the union and that the employers would be paid by separate checks with no taxes withheld. The employees agreed to the plan; the amount of the separate checks, without withholding, approximately equaled the net amount the employees would have received under the union rate after withholding. Tr. 2056, 2328, 2373.

The company also used separate checks—with no reduction for withholding—for holiday pay of union workers, for bonuses for salaried employees and for pay to employees who worked during a strike (Pet. App. 4a; Tr. 678-680, 743-750). Moreover, in several instances workers requested and received permission to be paid "off the books" for their regular working hours (Pet. App. 11a). In 1979, the company began to pay these amounts either directly in cash or by checks made payable to cash (Pet. App. 12a).

From 1976 through 1979, the company made virtually all overtime, bonus, and holiday payments "off the books," maintaining records of those payments on payroll registers kept separately from the registers that were sent to Citytrust

Bank (Tr. 155-156). Those payments were not reported to the Internal Revenue Service (Pet. App. 4a). Initially, the payments were recorded in a "materials purchased" account. After April 1978, when the company's accountant became suspicious of the increasing size of that account, the payments were recorded in a "labor purchased" account (Tr. 803, 4981; Pet. App. 4a). When the accountant questioned petitioner Roderick MacKenzie and the company's bookkeeper, he was told that the company was using more independent contractors. He was not told that regular employees were involved, and he was not shown the separate payroll sheets (Tr. 5684-5688, 5723-5728).

In 1977, petitioners established a division of the company to do painting jobs with non-union employees at fixed hourly rates. The non-union workers were supervised by Dennis McDevitt, who had previously worked as an outside contractor for the parent corporation. Petitioner Malcolm MacKenzie directed McDevitt to hire workers and made decisions concerning raises for the non-union workers. When contacted concerning loan applications, the MacKenzies verified that McDevitt and some of his men were employees of the parent company. Originally, McDevitt received a payroll check from the company for the wages of the non-union workers and paid the non-union workers in cash. The wages paid to the non-union workers were not reported to the Internal Revenue Service, nor were income or social security taxes withheld. In 1979, after the company had come under investigation by the Internal Revenue Service, the company notified the non-union employees that they could choose to go on the regular payroll. At the same time, the company also prepared copies of Form 1099, the document that must be filed if an independent contractor is paid $600 or more, for those workers who chose not to be paid from the regular payroll. Pet. App. 5a, 12a.

2. The court of appeals affirmed petitioners' convictions. (Pet. App. 1a-12a). It rejected petitioners' contention that their convictions were invalid because of uncertainty in the law concerning the status of workers as employees or independent contractors. The court found that there was not "any doubt—much less a reasonable one" that the workers involved in this case were not independent contractors, but were employees of the company, as to whom petitioners had a duty to withhold income and social security taxes (Pet. App. 11a). The court concluded that petitioners had failed to state any "plausible claim that, as applied to them, the statute and regulations [distinguishing between employees and independent contractors] were impermissibly vague" (Pet. App. 13a). In addition, the court found that petitioners' conduct revealed a "subjective belief in the unlawfulness of the conduct" (Pet. App. 16a).

The court also rejected petitioners' contention that criminal penalties were barred by Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2885-2886, a provision that protected employers from civil liability for treating workers as independent contractors, when that treatment was consistent and had a reasonable basis. The court found that Congress "could hardly have intended to abate criminal prosecutions where there is not only a lack of good faith but also deliberate tax evasion with concealed records and with intent to defraud" (Pet. App. 14a).

ARGUMENT

The decision of the court of appeals is plainly correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Petitioners first contend (Pet. 11-17) that they lacked the requisite intent to violate the tax laws. Because the status of some of the company's workers presented novel

and uncertain questions of tax law, petitioners argue, they cannot be prosecuted for their failure to treat the workers as employees for the purposes of income tax and social security tax withholding. The court of appeals correctly rejected this contention.

In general, the status of a worker is to be determined in accordance with the common law definition of an employee. See Section 3121(d)(2) of the Internal Revenue Code of 1954 (26 U.S.C.). The critical test is whether the person for whom services are performed "has the right to control and direct the individual who performs the services" (Treasury Regulations on Employment Tax, 26 C.F.R. 31.3401(c)-1(b)).

This standard is sufficiently certain to support petitioners' convictions. It is well established that vagueness challenges to statutes that do not involve First Amendment freedoms must be examined in light of the facts of the case at hand. *United States* v. *Mazurie*, 419 U.S. 544, 551 (1975); *United States* v. *National Dairy Products Corp.*, 372 U.S. 29 (1963). Thus, a defendant's challenge to the tax laws must be specific rather than facial. Moreover, the defendant cannot rely on hypothetical situations to demonstrate uncertainty in the law. *United States* v. *Irwin*, 354 F.2d 192, 196 (2d Cir. 1965), cert. denied, 383 U.S. 967 (1966). As the court of appeals noted (Pet. App. 12a-13a): "That the statute and regulations may present some doubtful cases does not mean that they are void for vagueness."

As applied to the facts of this case, the standards for determining the existence of an employer-employee relationship provided ample guidance. As the court of appeals noted (Pet. App. 11a), it is clear that the union painters who were paid, without withholding, for overtime and holiday work were employees, since they were paid as employees for their regular working hours. Nothing in the record remotely

suggests that, during the times the workers were being paid "off the books," their working arrangement—particularly the nature of the control exercised over them—was different from when they were on the regular payroll. Plainly, the purpose of petitioners' scheme was simply to enable the company to save labor costs at the government's expense.

The status of the non-union employees was also clear-cut. Petitioner Malcolm MacKenzie directed McDevitt to hire specific workers and decided on pay raises for workers. Petitioners Malcolm and Roderick MacKenzie both told financial institutions that McDevitt and some of his men were employees of the corporation. Moreover, petitioners' failure to file the required 1099 forms was inconsistent with a good faith belief that the workers were independent contractors.

The absence of any uncertainty in the law as applied to petitioners' workers distinguishes this case from the cases on which petitioners rely: *James* v. *United States,* 366 U.S. 213 (1961); *United States* v. *Mallas,* 762 F.2d 361 (4th Cir. 1985); *United States* v. *Dahlstrom,* 713 F.2d 1423 (9th Cir. 1983), cert. denied, 466 U.S. 980 (1984); *United States* v. *Garber,* 607 F.2d 92 (5th Cir. 1979); and *United States* v. *Critzer,* 498 F.2d 1160 (4th Cir. 1974). But even if the law as applied had been open to good faith differences of opinion, petitioners would not be entitled to have their convictions set aside. In *James,* from which the foregoing court of appeals decisions stem, this Court did not hold that uncertainty in the law negates willfulness as a matter of law.[2] And

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[2]In *James,* the defendant was convicted of attempted income tax evasion for failing to report embezzled funds. This Court held such funds taxable, overruling a prior decision, *Commissioner* v. *Wilcox,* 327 U.S. 404 (1946), in which it had held to the contrary. Despite the holding as to the taxability of embezzled funds in *James,* this Court reversed the conviction. In a plurality opinion (366 U.S. at 221-222), three Justices concluded that willfulness could not be proved so long as

this Court has never so held. Indeed, such a holding would conflict with the settled principle that the element of willfulness "relieve[s] the statute of the objection that it punishes without warning an offense of which the accused was unaware." *Screws* v. *United States*, 325 U.S. 91, 102 (1945); see *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942); *Gorin* v. *United States*, 312 U.S. 19, 26-28 (1941); *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 502-503 (1925).

In this case, there was abundant evidence of willfulness: petitioners clearly knew that their workers should be classified as employees, and they acted in bad faith in failing to withhold taxes. The company kept its payments in question on a separate set of books, it concealed the nature of the

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the tax statute contained the gloss placed on it by *Wilcox*, even though the vitality of *Wilcox* had been undermined earlier by *Rutkin* v. *United States*, 343 U.S. 130 (1952). The three dissenting Justices concluded that the element of willfulness depended on whether the defendant had actually relied on *Wilcox* (366 U.S. at 241, 242-243). The three concurring Justices, who dissented on the question of overruling *Wilcox*, necessarily agreed with the plurality that the conviction should be reversed, but two of them—Justices Black and Douglas—criticized the plurality's decision to make its holding prospective only and stated that, if *Wilcox* was correctly overruled, the defendant was guilty of violating the tax evasion statute (366 U.S. at 223-225). Thus, a majority of the Court did not subscribe to the conclusion that the uncertainty in the law negated willfulness as a matter of law. Moreover, this Court subsequently characterized *James* as holding merely that "[t]he requirement of an offense committed 'willfully' is not met * * * if a taxpayer *has relied in good faith* on a prior decision of this Court." *United States* v. *Bishop*, 412 U.S 346, 361 (1973) (emphasis added). Similarly, the Second and Sixth Circuits have held that uncertainty in the law does not negate willfulness where there was no connection between the uncertainty and the defendant's state of mind. *United States* v. *Ingredient Technology Corp.*, 698 F.2d 88 (2d Cir.), cert. denied, 462 U.S. 1131 (1983); *United States* v. *Curtis*, No. 85-5070 (6th Cir. Jan. 28, 1986) (Pet. App. 117a).

payments from the company's accountant, and in 1979 it began to pay workers in cash or by checks made out to cash. Pet. App. 11a.

2. Petitioners also contend that the courts below erred in holding that Section 530 of the Revenue Act of 1978 (92 Stat. 2885-2886), has no application to this case. This contention lacks merit.

Section 530 provides that if, prior to 1980, "the taxpayer did not treat an individual as an employee for any period" and all federal tax returns required to be filed after December 31, 1978, with respect to such individual "are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee," then for the purposes of applying withholding taxes "the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee." The statute was adopted to protect taxpayers who, having reasonably believed workers not to be employees, faced large assessments and penalties as a result of reclassification of their workers by the Internal Revenue Service. See H.R. Conf. Rep. 95-1800, 95th Cong., 2d Sess. 271 (1978); *Ridgewell's, Inc.* v. *United States,* 655 F.2d 1098, 1101 (Ct. Cl. 1981).

Nothing in the language or legislative history of Section 530 suggests that the statute was intended to preclude criminal prosecutions for willful violations of the withholding laws. Indeed, because it excepts employers who "had no reasonable basis" for their actions, Section 530 by its own terms does not protect the taxpayer who willfully fails to withhold taxes from the pay of an employee. A willful violation is " 'a voluntary, intentional violation of a known legal duty.' " *United States* v. *Pomponio,* 429 U.S. 10, 12 (1976). The willfulness standard is designed to separate the purposeful violator from the "well-meaning, but easily

confused, mass of taxpayers" (*United States* v. *Bishop*, 412 U.S. 346, 361 (1973)) and to avoid penalizing innocent errors made despite the exercise of reasonable care, *Spies* v. *United States*, 317 U.S. 492, 497 (1943). Thus, a taxpayer who willfully violates his duty to treat a worker as an employee and to withhold taxes from the worker's pay necessarily has no reasonable basis for his conduct. Petitioners' contention (Pet. 23-24) that Section 530 bars application of criminal penalties whenever a taxpayer's conduct is objectively reasonable, regardless of his good faith, is thus inconsistent with the plain language of Section 530.[3] Application of the statute does not depend on whether the taxpayer's classification of the worker was reasonable in the abstract.

The legislative history of Section 530 confirms that Congress did not intend to protect taxpayers who intentionally or willfully disobeyed their statutory duties. The Senate Report (S. Rep. 95-1263, 95th Cong., 2d Sess. 211 (1978)) specifically states:

> [A] taxpayer will not be considered to have acted in good faith if his treatment of individuals as independent contractors would, on the basis of the pertinent facts and circumstances, constitute negligence, intentional disregard of rules and regulations, or fraud within the meaning of section 6653 of the Code.

There is no merit to petitioners' claim (Pet. 23) that this comment relates only to the "good faith" standard that was used in the original Senate version of Section 530, not to the

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[3]The need for actual good faith reliance, rather than simply objective reasonableness, is further demonstrated by Section 530(a)(2), 92 Stat. 2885-2886, which provides that a taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if the taxpayer acted "in reasonable reliance" on (a) judicial precedent or rulings, (b) a past Internal Revenue Service audit, or (c) long-standing industry practice.

"reasonable basis" standard that was ultimately enacted. The conference committee report (H.R. Conf. Rep. 95-1800, 95th Cong., 2d Sess. 271 (1978)), explains that the final bill is substantially the same as the Senate Bill, and that the final version followed the text of the House Bill for "technical reasons."[4] Indeed, the substantial identity between the standards used in the two versions is demonstrated by the fact that the "good faith" requirement in the Senate Bill would be satisfied by the same factors that establish "reasonableness" under the final version of the statute: the taxpayer's reliance on past audit practice, his reliance on legal precedent or rulings, or his reliance on a recognized industry practice. See Pet. App. 43a-45a.[5]

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[4]Petitioners incorrectly contend (Pet. 23 n.13) that *Ridgewell's, Inc.* v. *United States*, 655 F.2d 1098, 1104 (Ct. Cl. 1981), supports their contention that the legislative history of the Senate Bill is irrelevant. In contrast to the mere change in language used to describe the standard involved in this case, *Ridgewell's* dealt with a change in the bill that was specifically designed to limit the requirement of treating employees consistently to returns filed after December 31, 1978. See Pet. App. 26a-27a.

[5]Even under the standard proposed by petitioners, their conduct was *not* objectively reasonable. Petitioner Malcolm MacKenzie's testimony reveals that the classification of workers as employees or independent contractors was entirely arbitrary: he testified that the sole basis for the classification was whether taxes were withheld (Tr. 6901-6902). In light of petitioners' control over their workers at all times, there simply was no objectively reasonable basis for classifying the workers as independent contractors.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1986

DOJ-1986-05

FILED
MAY 29 1986
JOSEPH F. SPANIOL, JR.
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Respondent.

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REPLY BRIEF OF PETITIONERS

In its Brief in Opposition, the Government seeks to block review in this Court by masking a clear conflict among the circuits and by persistently misinterpreting an important statutory tax relief provision.

1. The Government first urges denial of the petition for certiorari on the initial question presented by petitioners—whether uncertainty in the substantive tax law can be ignored in a federal criminal tax prosecution (Pet. O, 2)[1]—by asserting

1. References in this Reply Brief are indicated as follows:

   1. To the numbered pages of the Petition (Pet. ____);

   2. To the numbered pages of the Appendix to the Petition (____a);

   3. To the numbered pages of the Brief for the United States in Opposition (Br. Opp. ____).

that the decision below conflicts with no other opinions of any court of appeals or of this Court (Br. Opp. 5). This claim is in blatant disregard of: (a) the conflict between the rule applied by the Second Circuit in this and one earlier case and that adopted by at least three other circuits, and (b) the plurality opinion and holding of this Court in *James v. United States*, 366 U.S. 213 (1961).

A. As the Government obliquely recognizes, the court below has proclaimed in this case—relying upon its previous decision in *United States v. Ingredient Technology Corporation*, 698 F.2d 88, 96-97 (2d. Cir.), *cert. denied*, 462 U.S. 1131 (1983), that uncertainty in the tax laws may not be considered unless the defendant "genuinely thought what he was doing was lawful" (16a). What the Government ignores is that the Fourth, Fifth and Ninth Circuits, in direct conflict with the Second Circuit's holdings in *Ingredient Technology* and in this case and the Sixth Circuit's holding in *United States v. Curtis*, 782 F.2d 593, 599-600 (6th Cir. 1986), have held that the impact of uncertain tax obligations in a criminal tax prosecution does *not* depend on whether the taxpayer was personally misled by such uncertainty. *United States v. Mallas*, 762 F.2d 361 (4th Cir. 1985); *United States v. Dahlstrom*, 713 F.2d 1423, 1427-28 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984); *United States v. Garber*, 607 F.2d 92 (5th Cir. 1979) (en banc); *United States v. Critzer*, 498 F.2d 1160 (4th Cir. 1974). One of these courts has expressly held that uncertainty or confusion in the substantive tax law "does not depend on whether the defendant actually knew of" such uncertainty. *United States v. Garber*, 607 F.2d at 98, citing *United States v. Critzer*, 498 F.2d 1160.[2]

That there is in fact a conflict among the circuits, contrary to the Government's assertion, is recognized by commentators:

> Some circuit courts have held that objective uncertainty in the tax laws has little bearing on the subjective question of whether the defendant willfully violated those laws, ab-

2. The Sixth Circuit in *Curtis* expressly "decline[d] to follow" and rejected the reasoning of *Garber*. 782 F.2d at 599.

> sent a factual link such as the defendant's reliance on a particular judicial or administrative ruling or advice from informed counsel. Other circuit courts have held that objective uncertainty can absolve the defendant, as a matter of law, regardless of subjective factors such as the defendant's intent and knowledge.

Note, *Uncertainty in the Law: An Uncertain Defense in Criminal Tax Prosecutions*, 39 Tax Lawyer 387 (1986).

> Since the *James* decision, various circuits have issued conflicting decisions regarding the effect of uncertainty of tax law on willfulness from both substantive and procedural perspectives.

Elliott, *CA-9 In Dahlstrom Analyzes Effect of Tax Law Uncertainty on Criminal Prosecutions*, 62 J. Tax'n 150 (1985).As these authors make clear, *Critzer, Garber* and *Dahlstrom* conflict with *Ingredient Technology*. The Government's position to the contrary may stem from its erroneous assertion that petitioners "contend (Pet. 11-17) that they lacked the requisite intent to violate the tax laws" (Br. Opp. 5). In fact, petitioners seek review of the following question: whether, *regardless of the taxpayers' subjective intent*, the substantive law relating to the classification of construction workers for tax withholding purposes was, during the tax years in question, so confusing, conflicting and uncertain that as a matter of law the claimed tax duty was not sufficiently "knowable" so as to sustain a criminal conviction for a willful violation of that duty. *United States v. Mallas*, 762 F.2d at 363.

The Government attempts to evade the clear conflict among the circuits by claiming there is an "absence of any uncertainty in the law as applied to petitioners' workers" (Br. Opp. 7). This ignores that the underlying tax obligation in this case—the classification of workers for withholding tax purposes—has had a virtually unprecedented history of ambiguity, confusion and inconsistency expressly acknowledged by Congress in its enactment of § 530 of the Revenue Act of 1978 (46a).

This significant and growing conflict, which the Government seeks to disguise, merits resolution by this Court.

B. The Government also mischaracterizes this Court's leading case on uncertainty in criminal tax prosecutions, *James v. United States*, 266 U.S. 213. The Government argues that in *James* this Court "did not hold that uncertainty in the law negates willfulness as a matter of law" (Br. Opp. 7). However, that is precisely what the *James* majority did conclude; reversing defendant's conviction "outright", ordering a dismissal of the indictment and expressly rejecting Justice Harlan's suggestion that James be re-tried to determine whether or not he had in fact been aware of and acted in reliance on the uncertain state of the substantive tax law. 366 U.S. at 222, 244, 248.

As one commentator has noted:

> [I]n *James*, a taxpayer was convicted of tax evasion for failing to report embezzled funds. The Supreme Court squarely overruled [*Commissioner v.*] *Wilcox* [327 U.S. 404 (1946)] and held that embezzled funds were taxable. Nonetheless, the Supreme Court reversed the defendant's conviction, holding that the uncertainty of taxability of embezzled funds created by *Wilcox negated willfulness as a matter of law, regardless of the defendant's actual reliance on Wilcox.*

Elliott, *CA-9 In Dahlstrom Analyzes Effect of Tax Law Uncertainty* at 150 (emphasis added).

2. The Government's assertion that the court of appeals correctly decided the second quesiton presented here—whether § 530 of the Revenue Act of 1978 has any application to a criminal tax prosecution (Pet. O, 2)—flies in the face of the plain language of the statute, of explicit legislative admonitions that its "reasonable basis" relief provision is to be "construed liberally in favor of taxpayers," H.R. Rep. 95-1748, 95th Cong., 2d Sess. at 5 (1978) (35a), and this Court's requirement that an "employer's obligation to withhold [must] be precise

and not speculative." *Central Illinois Public Service Company v. United States*, 435 U.S. 21, 31 (1978).

The Government continues in its unwillingness to acknowledge Congress' explicit adoption of the House of Representatives' objective "reasonable basis" standard in the final version of § 530 rather than the Senate's state-of-mind "good faith" standard. Section 530(a)(2) sets forth what the subsection title states is "*one method* of satisfying the requirements of paragraph (1)" through "reasonable reliance" on any of three specific precedents (emphasis added). Contrary to the Government's suggestion (Br. Opp. 10 n.3 and 11), these specific precedents of § 530(a)(2) are not the *exclusive* bases for the safe-haven relief. Section 530 (a)(1) provides a residual safe-haven for a taxpayer who has had *any* "reasonable basis" for his treatment of a worker as a non-employee. Both the Report of the House Ways and Means Committee (31a) and the Joint Committee on Taxation (82a) confirm this statutory structure by stating that the three statutory safe-havens of § 530(a)(2) are merely examples and not meant to exhaust the circumstances under which a "reasonable basis" could properly be found:

> The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as other than an employee *are not the exclusive ways of meeting the Act's reasonable basis requirement*. A taxpayer who can demonstrate a reasonable basis for the treatment of an individual as other than an employee in some other manner also is entitled to termination of employment tax liabilities.

H.R. Rep. 95-1748 at 5 and Staff of the Joint Committee on Taxation, 95th Cong., 2d Sess., *General Explanation of the Revenue Act of 1978* at 302-303 (Joint Committee Print 1979) (36-37a, 87a) (emphasis added).

What the Government characterizes as "the substantial identity between the standards used in the two versions" of the bill

(Br. Opp. 11) and its reliance on the superseded Senate report (Br. Opp. 10) are unsupportable. Although the "good faith" concept of the discarded Senate bill would still be satisfied by the three express factors set forth in the statute as enacted, such factors are but "*one method*" of meeting the non-exclusive "reasonable basis" test. Thus, the description of "good faith" contained in the discarded Senate Report and relied on here by the Government is a dead letter, having no bearing on § 530 as enacted in its final form. Even though the changes in the Senate version were later described by the House-Senate Conference as having been made for "technical reasons," H.R. Conf. Rep. 95-1800, 95th Cong., 2d Sess. 271, *reprinted in* 1978 U.S. Code Cong. & Ad. News 7198, 7266, it does not follow, as the Government suggests (Br. Opp. 11), that the changes were insignificant.[3] In enacting the far-reaching relief provisions of § 530 and potentially affecting great numbers of employers subject to federal withholding obligations, Congress unambigiously rejected the "good faith" measurement and instead adopted a test which now defines the duty to withhold *solely* by reference to an objective standard of conduct. Thus employers facing criminal charges stemming from a misclassification of workers for tax purposes should be afforded what petitioners here were completely denied: an opportunity for the jury to determine whether—whatever their subjective intent—their classification had any "reasonable basis" within the meaning of § 530(a) of the Revenue Act of 1978, as enacted.

The Government's fall back position that petitioners' conduct could not in any event be deemed "objectively reasonable" (Br. Opp. 11 n.5) underscores petitioners' claim that the

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3. The entire discussion of § 530 in the Conference Report on the 1978 Revenue Act legislation is contained in less than one page of a 120 page report; its complete description in the General Explanation of the Revenue Act of 1978, prepared by the Staff of the Joint Committee on Taxation, comprises only four and one-half pages of a 468 page report. Given its context, the conferees' characterization of the change in § 530 as "technical" is surely meaningless. In light of the massive scope of the Revenue Act of 1978, it would not have been unreasonable for the conferees to have labeled § 530 in its entirety as "technical."

jury and not the Government should have made the determination of whether or not they had a duty to withhold from the payments at issue. Once it is recognized, as it has been here (27a), that the requirements of § 530 were otherwise met, a jury could have readily found that, under the standards of § 530, the taxpayers were under no initial duty to withhold taxes from the payments in dispute. The Government's conclusory description of petitioners' conduct as unreasonable emphasizes that there was an issue that the jury should have been allowed to consider. If the jury had not agreed with the Government's contentions, it might have voted an acquittal notwithstanding petitioners' subjective intent.

Left unreviewed by this Court, the judgment of the court below that § 530 can be properly ignored in this tax prosecution will: (1) seriously undermine a host of civil penalty provisions contained in the Internal Revenue Code,[4] and (2) constitute approval for denying the jury the opportunity to consider the Government's obligation to prove in withholding cases what it must prove in every tax prosecution: "that there was a tax owed to it by the defendant." *Elwert v. United States*, 231 F.2d 928, 932 (9th Cir. 1956).

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4. *See* Petition at 24 n.14.

CONCLUSION

For these reasons, then, this Court should—and petitioners request that it does—issue its writ of certiorari to review the judgment of the court below.

Respectfully submitted,

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May 29, 1986